PLAN YOUR OWN SECURITY

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by

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TO THE READERS
OF THIS BOOK

PREFACE

THE self-reliant person is ordinarily faced with two great financial problems in life—one that of earning enough money to cover immediate needs and make possible adequate provision for the future, and the other that of making the most advantageous use of his savings. Countless persons who solve the first problem fail to conquer the second. Quite aside from the untold grief resulting from the actual loss of savings, it is safe to say that the great majority of those who accumulate competences do not manage their affairs in such a way as to secure for themselves and their families the benefits they might obtain. There is a surprising amount of ignorance even among generally intelligent and well-informed persons concerning the instrumentalities through which savings can be put to work, and my principal purpose in writing this book has been to describe those instrumentalities and to discuss their adaptability to certain common situations.

Indeed I have gone further and have not hesitated to express opinions as to the relative merits

of different methods of utilizing savings and to give general advice as to the types of insurance policies, annuities, and securities best suited to the individual without special technical knowledge. There are exceptions to almost every rule, and it must be thoroughly understood that the views expressed apply only to normal cases. An instance is the rather negative opinion given of endowment insurance. Generally speaking it is not the best kind of life insurance, but there are doubtless particular situations to which it is ideally suited. Any person contemplating a plan for security must study his own circumstances, and, if this book enables him to do so intelligently and then to formulate a program well suited to his and his family's particular needs, it will have achieved its object.

WILLIAM LAW.

NEW YORK CITY,
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Chapter One

LIFE'S FINANCIAL HAZARDS

THE purpose of this book is not to urge thrift, nor to tell people how to make money. When one is so situated that he cannot hope to do more than provide his family with a decent living, carry enough life insurance to tide over a short transition period, and possibly build up a small savings account, much thought of the future is worse than a waste of time—it is a cause of useless worry. A person so circumstanced must, of necessity, rely largely on government or charity coming to his aid if need arises. Even saving can be overdone. There is no wisdom in suffering present penury to avoid the possibility of future poverty. Fortunately, however, there are many persons with sufficient incomes to plan for the future, and sufficient sense of the realities of life to want to do so. Despite their reputation for thriftlessness, Americans by the millions are constantly making provision for the future. They buy insurance, build up savings accounts, buy homes, and invest

(or think they invest) in securities, but too often these things are done not in pursuance of orderly, well-considered plans, but on impulse or as a result of the urging of salesmen or of having some extra cash available.

The old maxim that a penny saved is a penny earned should be revised. A penny saved too often means a penny lost. Savings do not take care of themselves. Their disposition and management should be carefully planned so that they will produce the greatest possible amount of security and freedom from worry. A sound financial program should envisage the sums which may be expected to be available for building an estate, the specific contingencies to be provided for in the order of their importance and urgency, and the various means of making proper provision for each of them.

What are the hazards which make saving in some form so necessary? The greatest for any man who has a family or may acquire one is death and the permanent loss of income on which his family depends. The only practicable means of providing against this eventuality is life insurance, but this recourse is open only to those in good health. One who waits too long may become ineligible. For this reason, and because the protection of his family is a man's primary duty, adequate life insurance must in

nearly every case be the first step in a plan for security.

Disability is the next thing to provide for, but the necessity for taking it into account in a financial plan varies according to the individual circumstances. For anyone whose position is such that his earning power will not be greatly affected by disability of short duration, no special provision for such disability is necessary. Others may rely on savings, if they are adequate, and, if not, they can take out accident and health insurance at small cost. Permanent disability is probably the greatest misfortune of all from every point of view, and one of the most difficult for which to make adequate financial provision. None of the stronger insurance companies offers separate policies which satisfactorily cover this risk, and while some of them do, upon payment of additional premiums, add permanent disability riders to life insurance policies, the form of protection is necessarily limited in extent by the amount of life insurance carried and, as we shall see later, is somewhat expensive. Unless, however, a person has protection of this kind, about all he can do is to hope that he will escape becoming incapacitated, at least until he has acquired a competence, and, incidentally, to drive carefully and cross with the green lights. Happily, permanent disability, or, to put it more

accurately, long-continued inability to pursue one's occupation, is not common at the younger ages.

There are, of course, almost innumerable contingencies which may necessitate extraordinary expenditures. Illness, operations, and dental care are the most common, but many other situations arise which cost substantial sums of money. The prudent person will want enough in the bank to provide for them and will plan his affairs to that end. It will be his first thought after life insurance.

The degree of risk of unemployment to which a person is subject depends very largely on his own circumstances. If he has been in government service for some time, or either occupies a key position or is an employee of long service in a strong corporation, the chance of losing his position is not very great. For most salaried persons otherwise situated it is, as we have recently seen, a very real hazard. Usually the only possible provision for such a contingency is to save and build up an estate. A person whose position is vulnerable in this respect must, if he is wise, devote a larger part of his income to his plan for security than one more fortunately situated.

Nearly everyone wants to look forward to an old age which he can spend in leisure if he is so inclined, free from acute financial problems.

This aspiration differs from the subjects heretofore considered in that everyone knows approximately when, if he survives, he will reach the normal retirement age, and can intelligently provide for that period of life. There are three general methods of doing so—purchasing annuities or retirement income insurance, having one's financial affairs handled by a trustee, and managing one's own investments.

A few years ago, this would have about completed a list of the events and hazards for which a financial program should make provision, but recent financial developments in the United States and other nations have raised the spectre of inflation, and while there is perhaps only a remote possibility at worst that real inflation will materialize, the danger is too much in the public consciousness to be ignored in formulating a financial plan.

The word inflation has many meanings. It is sometimes defined as the overissue of currency, or an increase in the circulating medium without a corresponding increase in the production of goods. What most people probably have in mind when they talk of inflation is merely a general increase in prices arising from any cause, but a mere rise in price level is an ordinary phenomenon and should give no concern to the conservative investor. The general price level is

constantly changing, even though only minutely. Aside from these minor fluctuations, economic history has been characterized by successive periods of rising and falling prices, and however desirable it might be to have a stable price level, the actual accomplishment of any such thing appears to be remote at best. The business cycle will probably be with us in some measure at least for a long time to come, but there is no real reason why the possibility or even certainty of inflationary prices in this sense should greatly influence the formulation or maintenance of a plan for security.

To be sure, a dollar invested in a fixed obligation during a period of low prices and repaid when prices are high means an actual loss in spending power to the investor, but on the other hand, he profits in the reverse circumstances. A plan for economic security must envisage a long time in the future, which, if the past be any guide, will include recurring periods of high and low prices. Life insurance premiums will be paid, savings deposits will be made, and securities and annuities will be purchased year after year. The securities will likewise mature, and the savings deposits will be withdrawn throughout the same period, while annuity income will cover another period of long duration. The insured may die, of course, when prices are high or when they are

low, but the proceeds, whether payable in a lump sum or otherwise, will probably be spent over a period comprising several cycles of rising and falling prices. It will all pretty well average up in the long run, without serious detriment to anyone who has carried out a sound financial program.

Even a person who knew certainly that the price level would continuously advance would be unable in many respects to plan his program in such a way as to avoid loss of purchasing power. Life insurance offers the only practicable financial protection against death and is essential for everyone with dependents whose income consists largely of earnings. It is better to leave somewhat depreciated dollars than none at all. Likewise, a savings account or liquid funds in some form must be maintained. The purchase of securities may be influenced by a prospective increase in the price level, but in the endeavor to avoid lesser losses, greater ones may be incurred.

In any event, it is difficult indeed to prophesy future changes in the price level or even the trend for any long period, and in formulating a financial plan, it may be just as well to ignore the whole subject. The average person has enough to worry about without attempting to gauge or even understand the various intricate factors influencing the general price level.

Lately, we have heard much of excess reserves, tremendous gold stocks, and the enormous credit inflation which they might make possible. Dizzy estimates are made of the bank deposits which existing reserves could support. The danger is not so great perhaps as might appear. A considerable expansion of bank loans is, indeed, greatly to be desired and will probably come in due course. That it will ever reach the proportions prophesied is more than doubtful. Undue credit expansion sets in motion natural forces which tend to control it, and the Federal Reserve Board has a considerable degree of power to regulate a situation of this kind. In any event, a rise of prices resulting from an enormous increase in bank credit must prove temporary and will of necessity be succeeded by a period of deflation. A long-term financial program will not be greatly affected.

The kind of inflation which would injure conservative investments is such uncontrolled and progressive reduction in the value of money as that experienced in France during the assignat period toward the close of the eighteenth century; in the same country, to a lesser extent, just after the World War; and in Germany at about the same period. Put briefly, outright inflation of this sort results from failing confidence in a nation's ability to meet its obligations.

A government usually borrows as long as it can, but when it can no longer do so, ordinarily resorts to the issue of so-called "fiat money" to pay its bills. There being no assurance that the government can fulfill its promises, people hasten to convert paper money into property or equities, and prices rise by leaps and bounds. The government must issue larger and larger amounts of money until finally it has little real value or even none at all. The end may come in a devaluation of the monetary unit, like that which occurred in France in 1926, or in such measures as those taken in Germany—the creation of a new monetary unit and a somewhat arbitrary revaluation of important kinds of fixed obligations.

When inflation of this kind takes place, the value of promises to pay expressed in money is disastrously affected. Even their monetary value tends to fall, but more important, of course, is the rapid fall in the real value of money. In France, when the franc was devalued, bonds, mortgages, and life insurance lost about four-fifths of their gold value, and in the final adjustment in Germany, the loss was somewhat greater. No one can prophesy what the exact effect will be on investments if outright inflation occurs, but it will undoubtedly be drastic.

The first question to be answered in considering the extent, if any, to which the danger of

outright inflation should influence the planning of a financial program is whether or not the risk is an imminent one in the United States, and the weight of expert opinion leans to the view that it is not. The nation's credit is extraordinarily good, and the public debt is not yet approaching the unmanageable stage. Despite unfortunate financial innovations and experiments which have been undertaken, the present administration has followed reasonably orthodox methods in its management of public finances and has iterated and reiterated its determination to preserve government credit. There is not the slightest indication of any widespread distrust of that credit, and it would take a considerable period for public confidence to be weakened to the point where a flight from money might take place. Even more important perhaps is the fact that the disastrous results of inflation have been demonstrated too recently and dramatically in other parts of the world for the lesson to have been entirely forgotten. The great majority of Americans are capitalists by reason of their ownership of savings accounts and life insurance policies, and it is inconceivable that they will sit idly by while the value of these things is destroyed. Recent developments have clearly indicated a crystallization of public opinion against inflationary policies.

Whatever danger there may be that uncontrolled progressive inflation will materialize comes from the continuing governmental deficits and the mounting national debt, and the unemployment which makes it difficult to reduce public expenditures. Moreover, people who get used to leaning on the government are hard to pry from the pay and relief rolls, and public extravagance is promoted by political factors. Continued deficits can have only one end, and it cannot be gainsaid that there is some real danger that eventually the country may simply drift into a condition in which inflation cannot be prevented.

The two most common methods of endeavoring to escape loss from inflation, or actually to profit by it, are the purchase of physical property —usually real estate—and speculation in common stocks. The difficulty is that each of these courses entails its own risks, and that when an attempt is made to insure against this remote contingency there may be failure to provide for the more actual hazards of life. Both real estate and common stocks will be discussed and their inflationary possibilities considered in subsequent chapters of this book. It is enough to point out here that ownership generally involves considerable risk of loss, that this risk is magnified when one undertakes to buy stocks with a

view to inflationary profits, and that it is extremely doubtful whether any common stocks constitute adequate protection against uncontrolled inflation. Only a person who has made adequate provision for the ordinary contingencies and has sufficient resources to afford the risk of loss should buy equities as an inflation hedge or otherwise. A person who, without adequate life insurance, a suitable emergency fund, and some definite provision for old age in the form of annuities or fixed-income securities, speculates in common stocks as protection against the risk of inflation is acting about as sensibly as he would be in taking out earthquake insurance on a New York house while neglecting to keep up his fire insurance and pay taxes. One might as justifiably refuse to take out life insurance on the ground that it will not keep the insured alive as on the theory that its value may be reduced by inflation. A somewhat remote contingency for which it is impossible to make certain and adequate provision should not stand in the way of securing protection against life's ordinary hazards.

Not so very long ago, the necessity, or at least the desirability, of planning for the future would scarcely have been questioned, but recently such wide publicity has been given to fantastic schemes for making every man a king,

or paying $200 a month to everyone over sixty, or living on "social credit," that many people seriously ask themselves why they should make sacrifices for the sake of future security when the government is going to see that everyone is amply provided for. The truth is, of course, that these chimerical plans will probably fall of their own weight, leaving no more impression on public memory than did Technocracy. If any of them is ever put to trial, it will not provide security for anyone. The utmost it will do will be to destroy the security that some have built up for themselves. However, the possibility that any of these hare-brained ideas will ever be actually adopted in these United States is surely small in the extreme. Whoever fails to save and plan because of these schemes is chasing a will-o'-the-wisp. The recently enacted Social Security Act is, of course, on an entirely different footing, and will be discussed at a greater length in a subsequent section of this book. Suffice it to point out here that its constitutionality is uncertain, that it may well prove unworkable in its present form, that it is largely dependent for effectiveness on state legislation, and that, even if its maximum hopes are realized, it will not for a long time to come provide more than bare subsistence to its beneficiaries. It certainly will not deter the prudent from making their own

financial plans for the future, although some day, to be sure, it may be on a sufficiently firm basis to warrant inclusion in them.

Government aid to the destitute is nothing new. Poorhouses, free hospitals, municipal lodginghouses, and the like have long been with us. Old-age pension and unemployment insurance plans mark an advance over such things, and are almost certain to be extended and liberalized, but there is not the slightest chance that any such plans will ever provide large enough benefits to satisfy a self-reliant American.

Chapter Two

LIFE INSURANCE—ITS PRINCIPLES AND STRENGTH

THE primary purpose of life insurance is protection against the financial losses occasioned by the deaths of people who earn money, but the institution serves other useful purposes and accounts for a very large proportion of the savings of the American people. Insurance-in-force, while woefully inadequate, nevertheless averages about $3,500 per family in the United States—far more than in any other country. Premiums consume in the neighborhood of 6 per cent of the national income. Some elementary knowledge of the business is not only desirable because of its tremendous importance but is necessary for the intelligent planning of a suitable individual insurance program.

If everyone were sure of living until, say, sixty-five, there would be little necessity for life insurance. One could simply plan to save enough so that at sixty-five there would be a sufficient fund to provide for dependents. But one may die

at any minute, and savings are likely to be quite inadequate if death occurs at an early age. While death for an individual is entirely uncertain as to time, it is possible to foretell very accurately by means of past statistics, the number who will die within a year, out of, say, a million reasonably healthy persons of a certain age. The simplest form of insurance would be for a group of persons of the same age to contribute to a fund which would be divided among the dependents of those dying during the year. If the survivors continued the same arrangement year after year, the number contributing would constantly diminish, while the number dying would increase. Finally, there would be only one member left, and his family would get no benefit at all from the contributions he had made.

Such an arrangement would be term insurance, and its objectionable feature (except in the case of group policies) is that indicated by the experience of the long survivors in such a group as that we have described. As a person grows older, the chance of his dying in any year increases, and if he pays a premium based each year on his mathematical chance of dying during that period, the premiums will increase until he cannot afford to pay them, and all that he has paid before will bring his family no benefits.

This characteristic of one-year term insurance

renders it unsuitable for most situations, and by far the greater part of life insurance sold today is of the level premium type under which the premium for a particular policy is fixed, and either from the beginning or after the first few years does not increase during the premium-paying period stipulated in the contract. If the policy only covers a limited number of years, as do five- or ten-year term policies, the premiums at the early ages are not vastly greater than the natural or one-year term premiums would be, but in the case of policies which provide lifetime protection, the difference is more substantial. Thus, one who would pay in the early years say eight dollars a thousand for one-year term insurance pays perhaps double that rate for a straight life policy. The insurance company accumulates the excess to use in later years for augmenting the premiums which will be less than the term premiums would be at the then attained ages. These excess payments and the interest they earn form the reserve, which is much the largest part of a life insurance company's liabilities (as the reserve is potentially owed to the policyholders). It is these excess payments which largely account for the vast assets of life insurance companies, and which at the same time build up value in the policies.

Similarly, it is this reserve accumulated under

a policy which enables the owner to borrow on it after it has been in force a few years or to realize a cash value on it, or which, if he does not wish to continue premium payments or feels that he does not need as much insurance, can be used as a single premium to purchase insurance on which no further payments will be required.

The premiums of any life insurance company depend on the mortality table it uses, the rate of interest it assumes it will be able to earn on its investments, and a cost factor known as "loading." Nearly all the large companies now use the same table, and there is little difference in their interest assumptions, but loading practices vary widely, some companies using figures near to their actual costs, others using very liberal loadings. As most of the large life companies are mutual, and as dividends on stock in the others are small in comparison with premium income, most of the profits are either paid to policyholders as dividends or go to increase surpluses and contingency reserves. The premiums, less the dividends, represent the actual or net cost of a particular policy, and this cost is determined in the long run by the actual mortality experience of the insuring company for that particular type of policy, the company's income, profits and losses from investments, and its total costs, including taxation, commissions, administrative

expenses, and so forth.* The experience of different companies varies considerably in all these respects, with the result that the net cost of a policy in one company may be substantially lower or higher than that of an identical policy in another company. The life insurance companies do not emphasize this fact, probably wisely, but it is of vital interest to insurance buyers and will later receive more detailed attention.

In investing funds or entrusting them to others, safety is the prime consideration, and in this respect, the record of the life insurance business is impressive. Over a long period of time, including many severe depressions and several nation-wide epidemics, the failure of an important company has been rare indeed. The obligations of many small companies unable to meet them have been assumed by larger companies under terms which ultimately worked out quite satisfactorily for policyholders. Eventual losses have been negligible in relation to the sums

* The question as to whether an insurance company suffers profits or losses from policies which lapse before they are eligible for cash value, and from the surrender charges made when policies are surrendered for cash, is too involved and controversial to be discussed here. In any event, the subject is not important to the buyer of insurance.

involved in the business.* During the recent severe depression, the important companies were able at all times to meet their obligations without borrowing money or even selling securities.

This highly satisfactory record is only partly attributable to able management and wise governmental regulation, although, as we shall see later, both have played a part. Certain inherent characteristics of the business have contributed to its success. First place, perhaps, should be given to the fact that premiums are largely based on the actual mortality records of a large number of people, and that the average length of life has rather steadily increased since the periods those records covered. To be sure, that part of the improvement resulting from the great reduction in infant mortality has not benefited the insurance companies, but even apart from that, people live much longer than they used to. If it were otherwise, the history of life insurance might not make such pleasant reading. Another

* The different fraternal organizations which include life insurance in their activities have not fared so well on the whole. They were not originally established on a sound actuarial basis, and when their members began reaching old age, difficulties were encountered. Most, at least, of the fraternal insurance organizations now in business have, however, been reorganized on the basis of standard mortality tables and are subject to state regulation.

inherent feature of the business greatly making for security is that only a comparatively small part of a life insurance company's liabilities is payable on demand, that even this part is not, in the very nature of things, likely to be called for all at once, and that a continuous, large inflow of cash is assured. Large surpluses and a large geographical distribution of business are additional safety factors.

Sound management and state regulation must be credited jointly with the conservative investment policies which have characterized the business. Companies in the United States are, for the most part, restricted in their investments to bonds, mortgage loans, and certain preferred stocks. During the postwar boom, there was a good deal of pressure brought to bear on life insurance management and insurance departments to relax these rigid requirements and permit the business to participate in the nation's development and in consequent profits by the common stock route. Fortunately, this pressure was successfully resisted, and the experience of recent years will probably assure the continuance of sound investment policies by life insurance companies for many years to come.

Some years ago, a book was published which both in title and contents very seriously questioned the security of the life insurance business.

Its method was to list particular investments and classes of investments which had meant more or less grief for insurance companies and to point out that, if the causes for the depreciation in these investments had been foreseen, huge losses could have been averted. The final impression it gave was that the insurance companies should have confined their investments to United States bonds, and bought those only with fingers crossed. No consideration was given to the fact that because the companies must keep their funds largely invested they cannot limit themselves to what they regard as ideal bonds. They must do the best they can with the available material. If they were to pursue any other course, they would lose more in income because of non-earning funds than they ever lose on investments which turn out badly. Moreover, as previously indicated, insurance companies do not often have to sell securities to raise cash and are not affected by temporarily depressed market prices of securities.

While numerous, and in some instances drastic, losses have inevitably been suffered by life insurance companies, their results have been a good deal better than those of the average investor buying similar categories of securities; and their ability to hold securities indefinitely and, in the case of defaulted mortgages, to

acquire, rehabilitate if necessary, and manage the pledged properties has often brought them out of apparently distressing situations without losses. In any event, the years 1932 and 1933 quite sufficiently tested the safety of the life insurance companies, and the answer is known to all.

As in every other line of business, some companies are stronger than others, and the selection of particular companies will receive attention in a subsequent chapter; but, in any event, it is comforting to know that both on its record and because of the nature of the business, the institution of life insurance, which must inevitably form the first line of defense in the average man's plan for his own and his family's security, is entitled to confidence.

Chapter Three

LIFE INSURANCE
WHAT KIND, HOW MUCH, AND IN WHAT COMPANY

THE average man has few more important financial acts to perform than the planning of an insurance program. He will probably keep on paying premiums as long as he lives, and if his income is moderate and he provides anything like adequate protection for his family, he will expend a rather substantial proportion of his entire earnings on insurance. The $5,000 policy on which he pays an initial premium of perhaps $25 will very likely cost him several thousands in the end. The vital importance of his insurance estate to his family requires no comment. Yet, it is undoubtedly a fact that the great majority of people give no real thought to insurance at all. Experience has demonstrated that very little insurance is taken out except as a result of personal solicitation by agents. One of them is occasionally shocked, though naturally gratified, by having a prospect take out a larger policy

than he has been canvassed for, but such occurrences are rare indeed. Too often the insured individual collects a somewhat heterogeneous collection of policies, taken out from time to time as his sales resistance is lowered, or as an agent's call coincides with an increase in his bank account. The type of policy purchased depends rather on what the agent wants to sell than on the buyer's needs; the latter gives little if any thought to his particular situation and none at all to the way in which the proceeds of policies are to be paid. The insurance purchaser, not the agent, should decide on the kinds of policies which will best fulfill his needs, the amount of insurance which should or can be taken out, the companies from which it is to be purchased, and the manner of its disposition.

In formulating an intelligent insurance program it is not necessary to understand the mathematical and technical methods used in evolving different types of policy contracts. All the buyer wants or needs to know is the protection offered and what it costs; therefore, our discussion will be confined to these two factors.

Term insurance has already been briefly described. The most common form of individual term insurance sold today is the five-, ten-, or twenty-year renewable term policy. The prem-

ium covers only the actual cost of insurance but does not change during the term. While a small reserve may be built up, there are no cash-surrender, loan, or other guaranteed values. If the insured dies during the term, the face amount is paid to the beneficiary. If not, neither the insured nor the beneficiary receives anything. A new term policy may then be taken out without medical examination, if the original policy so provided, but the premium will be higher. At the younger ages, premiums are very low, but at the older ages they are extremely high. Term insurance is suitable, therefore, in situations where only temporary insurance is needed. An instance is the coverage of a personal loan which the borrower expects to repay within a few years. He takes out term insurance payable to the lender to insure payment if he dies before repayment is completed.

Perhaps the most common purpose achieved by term insurance is the protection of children. They may be expected to become self-supporting in due course, and adequate provision during their minorities is preferable to inadequate insurance of longer duration. A father not financially able to take out sufficient whole-life insurance should buy term insurance of a period which will see the children to maturity.

This form of insurance may also be suitable

for a man with an aged dependent,* but in many cases aged dependents live longer than they are expected to, and the increasing premiums become burdensome. Another thing to bear in mind is that insurance no longer needed for the purpose originally in mind may be advantageously used to fulfill another need. If term insurance is purchased, the buyer should pay particular attention to the clauses relating to his privilege of renewing the policy, or of converting it to level premium insurance without medical examination. The longer such privileges may be exercised, the better.

Ordinary, or straight, life insurance is payable at the death of the insured, and a level premium is paid until he dies. A substantial reserve is accumulated, and after premiums have been paid for a few years, the policy has cash-surrender, loan, and other values. If premium payments are not continued, the reserve may be used as a single premium to purchase either a reduced amount of insurance payable at death, the policy then being commonly known as paid-up, or continued insurance of the full face amount of the policy for a limited period. If the latter option is selected, and the insured survives this period, the contract expires and

* A reversionary annuity, described on page 86, might also be appropriate in this situation.

there is no insurance left. Unless one has a mortal illness, it is usually inadvisable to choose this option. If one borrows against the reserve, it is, of course, reduced thereby, and if the full loan value is availed of and premiums are not paid, the contract expires. Premiums are lower on ordinary life insurance than on any other type of level premium insurance. We shall consider a little later the amounts of insurance which should be acquired, but in the great majority of cases, one simply cannot take out adequate insurance and must be content with what he can afford. When this is the situation, ordinary life, either alone or in combination with term insurance, is the most suitable kind.*

A limited payment life policy is payable at death, but premiums are payable only for a stated number of years or until the insured reaches a certain age. Premiums are larger and the reserve accumulates faster than in the case of an ordinary policy of the same amount, and the cash and other values are accordingly higher. Policies of this type, of which

* Some companies offer policies maturing or becoming paid up at very old ages—eighty to ninety—in order to sell what are in effect ordinary life contracts at different rates than those for their so-called preferred risk policies, sold only in large amounts. These policies are to all intents and purposes straight life, and should be so considered.

the twenty payment is the most common, are supposed to be most appropriate for persons whose incomes may be expected to decrease or stop altogether in later life. If one stops to consider, however, that the purchase of limited payment insurance reduces the amount he can buy, it becomes obvious that this kind of policy is suited only to those who, even at the higher premiums, can afford really adequate protection—a very uncommon situation, at least at the younger ages. Moreover, as we shall see, it is during the earlier years that the greatest amount of insurance is needed. One buying ordinary life may, when he retires or his earning capacity is reduced by age, cease paying premiums on all or part of it, converting it to paid-up insurance of smaller amount. The same result is achieved by combining ordinary life and term insurance. Anyone following either of these plans will have the higher protection when it is most needed, something he cannot obtain with limited payment insurance. A sales argument frequently advanced in favor of the latter kind of insurance is that it provides high cash and loan values. This feature, however, should certainly never be a controlling factor in buying insurance.

Endowment insurance is payable to the beneficiary if the insured dies during the period

of the policy and to the insured if he survives that period. It is therefore a combination of periodic savings and temporary life insurance. The period of an endowment is a stated number of years, or until a certain age is attained. The twenty-year endowment is the most common form. Premiums, reserves, and cash-surrender, and other values are much higher at the earlier ages than for limited payment policies of the same amounts and premium-paying periods. The insurance protection offered is not only small in relation to cost but ceases altogether when the policy matures. The person who has endowment insurance is inclined to include it in his mental calculations of protection afforded his dependents. If he survives and the policy is paid to him, he may invest it safely and pass it on to his heirs undiminished, but he is just as likely to spend it or to speculate and lose it, in which event his dependents will get nothing from it at all. When adequate insurance has been provided, endowment insurance may be used to provide for old age, but, as we shall see, there are better means of doing that. In most cases it is advisable to keep life insurance and savings distinct and separate.

These four kinds of polices—term, ordinary life, limited pay life, and endowment—are the standard forms of life insurance. Many com-

panies offer different types of term and endowment policies, designed to fulfill particular purposes, such as provision for the payment of mortgage loans or of expenses in connection with college education, under names indicative of those purposes, and it is a common practice to offer various standard policies, payable by their terms as income in one of the forms described in our next chapter, and sold as "income policies." Combinations of two or more of the basic types of policies are often put together in a single contract. Some of these combinations have met with wide favor and are offered by many companies. One of the most common is a combination of term insurance during the early years, usually five, and ordinary insurance thereafter. Such a policy appeals to a young man who has reason to expect that his earnings will soon increase. A large amount of insurance is obtained by payment of a small premium, while the objectionable continuous stepping up of premiums which occurs under pure term insurance is avoided. The disadvantage of such a policy is that it is predicated on hopes which may not be realized, and that the very postponement of payment which makes it superficially attractive does not fit into a sound plan for security. Another popular combination consists of a long term policy, usually for twenty years,

in conjunction with an ordinary life policy. The particular suitability of term insurance for the protection of children has already been noted, and the combination of ordinary life and term insurance is well suited to a man of moderate income who has a wife and children. The insurance will be larger until the children reach maturity. When the term insurance expires, possibly about the time the insured plans to retire, the premium decreases. Of course, ordinary life insurance and term insurance may be bought without recourse to any special contract, and greater elasticity can be achieved by doing so. It is possible, for instance, to decrease the term insurance as the children get older and smaller funds will suffice to care for them until maturity. If the buyer is in a position, however, to provide adequate insurance of the ordinary life type, it is usually advisable to do so. To be sure, the amount of insurance absolutely required tends to decrease as children become self-supporting and as the life income purchasable by the beneficiary for a stated amount of insurance becomes larger with advancing age. But, on the other hand, a man frequently improves his scale of living, and an income which in earlier years would have provided the sort of life to which his wife was then accustomed will no longer suffice. An ordinary life policy, remain-

ing in force for its face amount, actually provides more and more real protection as the years go by.

One is forced to the conclusion that while every kind of policy is well suited to certain special situations, the ordinary life contract, or such a policy in combination with term insurance, most often furnishes the best solution. These two policies offer the greatest protection in proportion to cost. The ordinary life is an elastic contract in that the guaranteed values permit of reducing or discontinuing premium payments in later years, while still maintaining substantial insurance. Ordinary life for lifetime protection and term insurance to cover needs which may be expected to terminate at a fairly definite time should, between them, answer nearly every requirement.

Several methods have been advocated for determining the amount of insurance a person should take out. One of them involves the estimation of his probable lifetime earnings, less personal expenses, and the computation of the present value of the differences on the basis of a somewhat arbitrarily selected interest rate. However interesting this process may be as a mathematical exercise, it is of little real value. Life insurance is an intensely practical matter and should be so regarded. Its primary purpose is to provide for dependents, and proper provi-

sion for them should be the determining factor in taking out insurance.

It is possible, of course, for the head of a family to make up a more or less detailed estimate of the income his family would, if he died, require year after year, with a view to providing sufficient life insurance to yield that income; but few men are fortunate enough to be able to pay for any such insurance coverage as a computation of this kind would indicate to be necessary, and, in any event, an estimate of expenses over a long future period is bound to be too largely conjectural to be of much practical value. The man of moderate income must consider not only what he would like to do, but what he can afford to do. In most cases he can hope for nothing more than to take out insurance which will provide his widow with a decent living, and possibly yield a little additional income during the period when children are growing up.

Circumstances alter cases, to be sure. A man's wife may be self-supporting. If there are no children, only enough life insurance is absolutely necessary to cover the expenses which illness and death and the consequent readjustments may entail. If there are children, an additional sum to provide for them during dependency is necessary. Even if a wife is not earning a living, she may be so situated that

there is reasonable ground for believing she can become self-supporting. In the great majority of cases, however, the head of a family will wish to make sure that, if he dies, his wife will be assured of at least a very moderate life income, and it should never be forgotten that insurance not definitely necessary at any given time may later become so, and that it may then be impossible to obtain it.

When the subject of the payment of life insurance proceeds is reached, we shall see that about $20,000 of life insurance must be provided by a young married man to assure his widow a life income of about $75 a month. This is hardly more than a bare living, and it is perhaps permissible to set that amount of life insurance as the minimum one should endeavor to take out. If it is not possible to pay for ordinary life of that amount, it may be advisable during the early years to consider the purchase of term insurance which may later be converted into ordinary life. Naturally, any one who is able will provide more than the minimum amount and, as his income increases, will augment his insurance to the point where it may be expected to take care of his widow comfortably during her entire life and to provide for the proper education of any children.

For the person who has substantial resources

in the form of cash or securities the problem of adequate life insurance is a little more complicated. Such securities will presumably be inherited by dependents, and the income either will be sufficient to support them or will supplement the insurance estate. It must be remembered, however, that settling an estate is a slow and sometimes expensive matter, and sufficient insurance should be carried to provide for the expenses incidental to the death of the head of the family, including death duties, and for the living expenses of the family until the estate can be settled in orderly fashion. An estate, including insurance, should be considered as a whole, and a person of really substantial means should seek expert advice in planning his insurance program.

Whoever has group insurance may, with certain reservations, properly count it in his insurance estate. Under a group insurance contract, all the employees of a company, or a large percentage of them, are insured without physical examination. This insurance is on the term plan but is not open to the objection of increasing cost which applies to individual term insurance policies, because the premium under a group contract is an average premium based on the age distribution of the insured employees, and this does not tend to change greatly, except in a

moribund company. An insurance company is satisfied with an average degree of health (the physical examination of applicants for individual policies being largely designed to overcome the natural selection against the company which would otherwise occur, and to assure a rather low average mortality during early policy years to compensate for the heavy initial expenses due to commissions, health examinations, and the like), and secures it in the case of group contracts by insisting that a very large proportion of all employees be included. Premiums are paid by the employer, who may, by agreement, make deductions from the insured employee's pay, to reimburse him in whole or in part. Usually, a maximum cost to the employee is guaranteed. The holder of a group insurance certificate may upon termination of his employment take out a level premium policy of the same amount without physical examination, but, of course, the premium is much higher, and this privilege is not often exercised.

As group insurance is term insurance, no equities are built up, and there are no loan or surrender values. The extent to which group insurance may be considered as secure and dependable rests on the certainty of continued employment. Either discharge from a position or the failure of the employer terminates the

insurance, and under either circumstance, the employee is not likely to be able to replace it at higher cost. On the other hand, any one with long service, or occupying a key position in a large and well-established company, may reasonably include his group insurance in his security calculations.

Everyone who has the opportunity of obtaining group insurance should do so, even though the employer contributes little or nothing to the cost. Because of the comparatively low selling and administrative expense, group premiums are even lower than individual term premiums. Insurance of this type is the cheapest insurance there is.

The proper kind and amount of life insurance having been decided on, the choice of the company or companies is next in order. Safety is the first requirement. The strength of the important life insurance companies has already been stressed, but insurance company failures have not been unknown, and the selection of a company in which one can have complete confidence is very important. Such failures as have occurred in the business have been due, for the most part, to fraud, mismanagement, or the formation of companies without sufficient resources to carry them through the early years, when expenses are high. Age is an indication of stability in any

industry, but for technical reasons, it is particularly important in life insurance. Although the quality of the younger companies is not to be impugned in any way, the average buyer of life insurance is strongly urged to purchase his insurance from the well-established companies. This does not mean that an insurance company must be in the hundred-year class, but one which has seen its early policyholders to old age, requiring, perhaps, fifty years, should be preferred, other things being equal.

Most of the small insurance companies are capably managed and as sound as one could ask, but even so, there is an element of strength in size. In the very nature of things, the larger companies are less vulnerable to epidemics, wars, and natural disasters than are the smaller ones, and fraud or gross mismanagement is less likely to occur, or, if it occurs, to do great damage.

There is, perhaps, some assurance to the prospective buyer if the surplus and contingent reserves are large in relation to total liabilities, but this figure may be so greatly influenced by accounting methods that too great reliance cannot be placed upon it. Good management is, of course, a very great factor of safety. A company's history and size furnish some indication of its management, and the proportion of income

absorbed by expense is another. Insurance manuals give the expense ratios of different companies, but generally speaking, a company with a low expense ratio sells low-cost insurance, and as the prospective buyer of insurance should carefully consider the comparative rates of different companies, it is scarcely necessary for him to consider separately the item of company expense.

Summing the matter up, the insurance buyer should select an old, large company, whose stability is a matter of common knowledge to all, and he will further protect himself in this respect, as well as more directly, by buying low-cost insurance. On two important counts, therefore, the cost of insurance in the different companies warrants careful attention.

Insurance is a financial business, and the layman is apt to believe that in such institutions there is little difference in rates. This is far from being the case. The costs of identical policies vary greatly between different companies. For technical reasons, a company's rate for one class of policy may be lower in comparison with the rates of other companies than for another type, but within each general kind of policy, the company whose cost is lower for one particular policy is at the head of the list for all policies of that kind, and, generally speaking, the low-cost

companies offer the best rates for all kinds of insurance.

There are some large stock insurance companies which offer nonparticipating policies, and for these policies the premium gives the cost. Most of the large insurance companies, however, are mutual, and some of the stock companies sell participating policies. It is probably fair to state that participating policies generally prove cheaper in the long run than nonparticipating ones. An insurance company must include some factor of safety in fixing premiums, and if it is not needed, this part of a premium is returned, in part at least, to the holder of a participating policy. To arrive at the net cost of a participating policy, the dividends must be deducted from the premiums. To be sure, future dividends are not guaranteed, but the insurance buyer may safely assume that past experience furnishes a pretty good guide to the future and that the company whose policy of a particular type has shown the lowest net premiums* over a period of years may be expected to continue to furnish low-cost insurance of this type. Companies themselves are glad to furnish premium and dividend histories

* The term is used in the sense indicated of premiums less dividends, not with the technical actuarial meaning of premiums based on mortality tables and interest assumptions without loading for expenses.

of typical policies, and net costs for standard policies issued by all of the companies are available in several insurance manuals. No difficulty is experienced except in the case of special policies not issued by all of the companies. These policies, however, may usually be pretty closely duplicated by combinations of policies in other companies and the corresponding costs compared. If comparison is desired between an endowment maturing after a stated period of years with one maturing at a given age, it is, of course, only necessary to take an age at which the two policies are identical, and the same holds true of limited payment life policies. Particular mention is warranted of policies issued by some of the large companies in units of $3,000 or $5,000 to selected risks. They are usually known as preferred or select policies, and naturally constitute very low-cost insurance.

It is sometimes argued that the surrender value should be deducted from the net premiums to give the true net cost. However true this may be in a technical sense, it loses sight of the purpose for which insurance is taken out. The average person takes out an insurance policy for the protection it affords his dependents. He pays the net premiums during the entire premium-paying period, and when he dies, the face amount of the policy is paid to the beneficiary. He does not

take out the policy in order to surrender it for cash, nor primarily to borrow on it. If he does have to borrow on it, the fact that he can borrow more on a higher cost policy is not by any means an unmixed blessing, as the protection is reduced by whatever amount he borrows. The person planning security should be interested only in the protection offered and in what he will have to pay for it.

Apart from weekly premium insurance, which is intended for people of very moderate incomes and is of necessity very expensive insurance, premiums are usually payable either in one sum, annually, semi-annually, or quarterly; and some policies may be paid for on a monthly basis. Single premium insurance is seldom possible or practicable, and, in any event, requires no particular explanation. The choice between the other methods of payment must rest on an individual's particular circumstances and his convenience. Any one who can plan conveniently to pay annually should do so. In the first place, the difference between two semi-annual premiums and one annual premium for the same insurance constitutes high interest on the amount retained by the insured for six months through the semi-annual payment method, and the same thing is true to a greater degree of quarterly payments, as compared with annual or semi-annual ones.

More important, however, each premium payment means an opportunity to neglect it or to be unable to pay it. One leaves home or is taken ill or forgets to pay the premium, and the insurance lapses. At best, it can be reinstated only upon evidence of good health, and, at worst, the insured dies without the protection. The less frequent the premiums, the safer is the insurance.

For much the same reason, a regular habit should be formed of paying premiums when they are due and not taking advantage of the thirty-one day grace period allowed. Paying regularly at the last minute simply takes away the cushion which the grace period should provide. If the insured regularly pays premiums when due, the grace period will mend the damage done by occasional neglect or misunderstanding. If he does not, the first untoward happening will mean the lapse of a policy.

The most common method of using the annual dividends declared on participating policies after they have been in force a few years is to subtract them from premium payments. A policyholder usually may elect, however, to have them paid in cash, leave them with the company at interest, or use them to purchase additional insurance. If one can afford to pay the full premiums, it is advisable to take advantage of one of the last two options. One results in increasing insurance,

while the other puts the dividends to work at a higher rate than can be obtained from savings banks. In the latter case, the amount on deposit may be drawn out at any time and may be considered as supplementing the policyholder's emergency fund.

Emphasis should be placed on the importance of reading very carefully one's life insurance policies before accepting them, and of making sure that their provisions are completely understood, not alone to prevent any possibility of misrepresentation or misunderstanding, but to make sure that the privileges, obligations, and restrictions of the contracts are clearly comprehended. The policies issued by the large companies are fairly standard in their general provisions, and a life insurance company is usually glad to pay its claims promptly and without quibbling, unless there is a question of fraud, or, in the early stages of a contract, of suicide. There may be, however, certain restrictions, such as those applying to airplane travel, which the insured should bear in mind.

There is no particular point in taking out life insurance which provides double the insurance for certain kinds of accidental death. Dependents require no more insurance when death is caused by an accident than when it comes in some other way. Mention was made in the first chapter of

this book of the so-called disability annuity rider, under which premiums are waived and an annuity is paid to the insured in the event he becomes totally and permanently disabled before a stated age—usually sixty. Such a contract protects in some measure against one of the worst of life's hazards, and, if it can be obtained at reasonable cost, is most desirable. Unfortunately, however, many at least of the low-cost insurance companies no longer offer this form of contract, and whoever buys high-cost life insurance to obtain the disability annuity rider pays more than it is worth. Moreover, contracts embodying this clause are treated as a distinct class in computing dividends, and past records indicate that experience with this class of life insurance policies is not likely to be such in the long run as to make high dividends possible. It is very much open to question, therefore, whether a policy carrying the disability annuity rider can be had at reasonable cost. Most companies do offer at a small additional premium a rider providing for the waiver of premiums in the event of the insured's total and permanent disability before the age of sixty, and this form of additional protection, though not perhaps of great importance, is well worth its small additional cost.

Insurance premiums are determined on the

basis of age nearest birthday. It is therefore advantageous to take out insurance shortly before the date midway between birthdays, rather than after, and as long as his life insurance program is incomplete, it is well for the insured to remind himself by calendar pad or otherwise a few weeks before this date each year that the subject should be considered. If payment of premium on some other date than the anniversary of the policy would be more convenient, it can usually be arranged by paying the pro rata part of the annual premium for the period from date of issue to the desired premium date. This permits a person to take out insurance just before his insurance age changes, but to spread payments over the year. It is usually good policy, too, when taking out a large amount of insurance, to divide it into several policies, thereby achieving greater flexibility.

Before turning to the question of beneficiary designation, it may be well to emphasize again the importance of an insurance buyer's deciding his own plan of insurance and choosing carefully the companies in which to insure. Life insurance agents are probably as honest as any other class of people—perhaps it would be well to say any other class of salesmen—, but, after all, an agent makes his living by selling insurance, and it is no more than natural that he should emphasize the

advantages and gloss over the disadvantages of the policy he is trying to sell and that he should put the company he represents in the best possible light. Experience shows that of two identical life insurance policies taken out twenty years ago in two of the leading companies, the net cost of one to date has been almost 30 per cent more than that of the other. The initial premium for a life insurance policy may not seem large, but when buying a life insurance contract, the purchaser enters upon a contract under which he will continue to pay premiums for a very long time. To the possessor of a moderate income who spends thousands of dollars on life insurance even a small difference in net costs means a substantial amount of money.

Chapter Four

LIFE INSURANCE—DISPOSITION OF THE PROCEEDS

THE part of a life insurance contract of greatest importance to those for whose protection it is taken out is that having to do with the disposition of its proceeds. Three points are involved—the designation of beneficiaries, the retention or abrogation of the right to change the designation, and the manner in which the proceeds are to be paid.

If insurance is made payable to the estate of the insured or to a trustee for the benefit of the estate, the policy is at all times subject to the claims of his creditors. At his death the funds will be paid to his estate and will not be available to his heirs until the estate has been settled—not a rapid process. These are serious disadvantages, and there are, at most, few situations which cannot be better met by some other means than making insurance payable to the estate. Indeed, such a designation robs life insurance of two of its most desirable

features—comparative invulnerability to the claims of the insured's creditors and quick availability to those whom it is intended to benefit. Moreover, as we shall see in connection with the general subject of taxation, the Federal Estate Tax law provides for exemption of the proceeds of life insurance up to $40,000 in amount if payable to named beneficiaries directly or in trust, and this exemption does not apply to insurance payable to the insured's estate.

The most common designation is that of a single beneficiary—usually the wife. Such insurance is not ordinarily subject to claims against the insured during his life or afterward, except that in some states if the right to change the beneficiary is reserved, the cash value is so subject. The insurance is paid directly to the beneficiary. If she dies before or at the same time as the insured and no other beneficiary is named, the insurance is payable to the insured's estate. One should therefore always name a contingent beneficiary or beneficiaries. Children are most often named in this capacity and need not be otherwise described, except that if there are adopted children or half-children, special reference to them should be made. Entering the names of children may lead to difficulty if more children are born subsequently. When more than one beneficiary is named, either in the first

instance or contingently, they may share equally, or a particular sum or fraction may be designated for each. In either case, provision should be made for the possible death of one or more of the joint beneficiaries. If two beneficiaries are named, or if more than that are to share equally, the proceeds may be made payable to them "jointly and to the survivor(s)." If one of them dies before the insurance becomes payable, his share will be paid to the surviving beneficiary or beneficiaries. If insurance is payable to more than two joint beneficiaries, in different shares, more exact directions must be given as to the payment of the shares of any who die before the policy becomes payable.

It quite frequently happens that the insured and the primary beneficiary die within a short time of each other, as the result of an accident. The general rule in the United States is that, if the beneficiary can be shown to have survived the insured even momentarily, the proceeds of a policy payable in one sum, or as much of them as is so payable, belong to the beneficiary's estate. To avoid this possibility and that of any litigation over such a situation, it is well to stipulate that a policy shall be payable to the first-named beneficiary only in the event that she survives the insured by, say, ten days.

When insurance is made payable to a trustee,

a separate agreement must be made with the latter, and a copy of this deed should be lodged with the insurance company. As the purpose of this kind of designation has usually to do with the manner in which insurance proceeds are to be paid, it will be discussed in connection with that subject.

If the insured pays the premiums, he should retain control of the contract by reserving the right to change the beneficiary, retaining possession of the policy, and stipulating in the application, if possible, that he may borrow on the insurance, assign it, or surrender it for cash, without the beneficiary's consent. The exemption from estate taxes of insurance payable to personal beneficiaries already referred to is not affected by the right to change the designation, and complete exemption from death duties depends, as we shall see later, not only on the irrevocable naming of a beneficiary, but on the latter's paying premiums.

When premiums are so paid, the most businesslike procedure is usually to assign the policy to the beneficiary, in addition to making the designation irrevocable. In the ordinary case, where a man takes out insurance and either pays for premiums himself or arranges to have them paid from his earnings, there is no good reason why he should not retain full control, except

possibly a desire to make sure that the cash value will be exempt from seizure by creditors. That, however, is not often a controlling consideration. There are ways of showing confidence in marital or other relationships that are more appropriate and less likely to prove embarrassing and costly than parting with control over insurance. An insurance company will not, under ordinary circumstances, change the beneficiary, make a loan, or record an assignment unless the policy is submitted, and care should therefore be taken to keep it safe. Anyone who has reserved the right to change the beneficiary may, of course, obtain a loan or sell the policy for cash without the beneficiary's consent by the simple expedient of first revoking the beneficiary designation and making the policy payable to his estate, but the necessity of doing so is avoided by reserving the right to do those things without consent of the beneficiary. Some companies, however, will not permit this reservation.

If insurance is made payable to designated beneficiaries, there are a number of ways in which the proceeds may be made payable. The first is in a lump sum. If there is only sufficient insurance to cover expenses incidental to the death of the insured, including estate and inheritance taxes, and the family's immediate needs, it should be payable in this way, and

in any event a sufficient amount for these purposes should be made immediately available. There are very grave objections, however, to having more than such an amount paid in a lump sum. The money comes into the possession of the beneficiary when he or she is least able to manage it wisely. Services in connection with the insured's final illness and death are likely to be somewhat overappraised by those who performed them if they know that the widow is receiving a large life insurance payment, and at such a time bills are not likely to be closely scrutinized. Relatives and friends may want to borrow funds for purposes which are doubtless desirable in themselves but provide no real assurance that the loans will be repaid. The beneficiary, herself, suddenly in receipt of a much larger amount of money than she is used to having, may be prone to extravagances she really cannot afford. More important than any one of these things, however, is the fact that few beneficiaries of life insurance have had any experience in investing funds. Many of them fall easy prey to the purveyors of fake securities and to fraudulent schemes of all kinds. Even if they escape these snares, they are likely to become the victims of well-meaning but unqualified advisers. A salaried man would scarcely ever choose to receive in one sum the present

value of his prospective future salary. Yet his position, if he did so, would not be dissimilar to that in which he puts his widow by making his insurance payable in one sum.

Insurance over and above a sufficient sum to provide for immediate needs should be made payable in such a way as to provide an income, and life insurance policies generally provide three options which accomplish this result. Under one of them, the principal sum is retained by the company, interest being paid to the beneficiary for a period of years or for life, the principal becoming payable at the expiration of the stated period or at the beneficiary's death, in accordance with the terms of the contract—ordinarily to the children. The policy states the guaranteed rate of interest, and if the company earns more than that on its investments, and the contract is participating, additional interest is usually paid.

A second income option provides for the payment of the insurance in installments, annual, quarterly, or monthly. The principal, plus interest at a stated rate on the funds left in the possession of the company, is used up in paying either an agreed number of installments, each of such amount, or installments of an agreed amount of such number, as the funds will provide. An installment contract may, for instance,

be so written that a monthly installment of $100 will be paid until the principal is exhausted, or that twenty annual installments will be paid. Whatever method is selected, the company will inform the policyholder of the minimum installment or the minimum number of payments guaranteed by it. If the contract is participating and the company earns a higher rate of interest than that stated in the contract, it will usually pay larger installments or pay them for a longer period than it has agreed to. The initial installment is usually paid when the claim is approved. This optional mode of settlement satisfactorily provides for many situations. Thus, if only a small amount of insurance is left after immediate needs have been provided for, it may be made payable in monthly installments for a year or two. This method of payment is also well adapted to provide for the care of children up to their maturity. As they approach that stage, the insured can gradually decrease the amount of insurance payable in this way.

The third option providing income, which is offered by most insurance companies, is the annuity or the income settlement. They are substantially the same and, as annuities will be described at some length when we reach the subject of old-age security, it will suffice to state here that this option provides a regular life

income to the beneficiary. The older the beneficiary is when the policy becomes payable, the larger the income will be for a given amount of insurance. Either a certain number of payments or payments aggregating the principal sum or half of it may be guaranteed; and if the beneficiary dies before the guaranteed payments have been made, the balance is paid to her estate or to a contingent beneficiary, either in installments or in one sum. Most mutual companies increase only the guaranteed payments, if excess interest is earned, but that is not invariably true. Any guaranty as to number or total amount of payments acts to reduce the annuity purchasable for a given amount.

These three optional methods of settlement, singly or in combination, can be used to meet almost any requirements. Thus, a man with a wife and young children may direct that, say, $2,000 of his insurance be payable in a lump sum to his wife, and that the remainder be paid to her as an annuity with twenty annual payments guaranteed. She will thus receive an income as long as she lives, and if she dies before the children have reached maturity, the policy will provide for the payment of the remaining guaranteed payments to their guardian. The insured may want to provide for larger payments during the period before the children may be expected

to become self-supporting, and in that case, he may have part of the insurance payable as outlined above, and part of it payable in installments over a certain period. If he does not die, and the children approach or reach maturity, he may make such changes in the contract as seem appropriate.

Whatever optional mode of settlement is selected, the insured should specify whether or not after his death the beneficiary will have the power to obtain the commuted value of the contract. Ordinarily, a particular method of payment is selected as in the best interests of the beneficiary, and withholding any power to change the terms of the contract is advisable. Moreover, the general doctrine is that the contract is not subject to claims of the beneficiary's creditors when the latter has no control over it. In a particular case, however, the insured may foresee the possibility of circumstances arising under which control ought to be lodged in the beneficiary. If this is done, it is well, if possible, to stipulate in the contract that it is to be exempt except as provided by law, from claims of creditors. The recent tendency of the courts appears to have been to rather favor the beneficiaries of income contracts, and such a stipulation might be upheld, even though the beneficiary were empowered to commute the policy.

Insurance companies in the United States do not generally act as trustees, and indeed most of them, at least, have no power to do so. The payments they make are made under definite contract and do not involve trusteeship. If the power is withheld from the beneficiary to change the provisions for payment, no change may be made, no matter what the beneficiary's need for such a change may be. On the other hand, if the beneficiary has the power to demand payment of the commuted value of any sums due under the contract, it must be paid on demand, even though such payment might in effect be directly contrary to the insured's wishes if he were alive. The insured may, of course, make part of the proceeds subject to the beneficiary's disposition and part of them not, but the insurance company can never be placed in a position of using its judgment in the matter.

If the circumstances of the insured are such that what he deems satisfactory arrangements can be made under definite contract, the modes of settlement offered by the insurance company usually offer the best solution. The insurance company charges no fee for the services it performs in this regard, and the minimum amounts which will be paid under any option are either definitely stated in the policy or may be readily calculated, or, if dependent on the beneficiaries'

age, are shown in a table which the company will gladly furnish. The insurance company in its calculations assumes a certain rate of interest which it believes it will earn on its funds. If these expectations are not realized, it must, nevertheless, pay the agreed amounts. If, on the other hand, it earns more than the assumed rate, it may pay more than the agreed sums.

Insurance companies will, of course, offer a policyholder or a prospective policyholder every possible cooperation in carrying out his wishes. All that is necessary is that he either write out in simple language or inform the insurance representative what his wishes are, and the company will see that they are properly expressed for inclusion in the contract, provided, of course, they are such that the company can properly accept them.

If the insured desires to have the proceeds of his insurance payable in a manner which the insurance company cannot provide, or if he wishes them managed by experienced persons for the advantage of his beneficiaries, or if he wishes them to be in the charge of a person or corporation which may use discretion in distributing them, he should make his insurance payable to a trustee beneficiary and draw a deed specifying the conditions under which they are to be handled and paid out by the trustee. A

copy of the deed should be attached to the insurance policy. Likewise, if the proceeds of the policy or part of them are payable directly to minors or to other incompetent persons, or are likely to become so payable, it is probably best to use the life insurance trust, as that procedure will avoid the necessity of having guardians appointed. Sometimes, too, in the case of a large estate and a substantial amount of insurance, the insured may deem it advisable to have the insurance proceeds or part of them merged with his estate, and the best way to accomplish this purpose is to have them paid to the trustee also appointed under his will. The limited exemption from death duties is not applicable in such a case.

The general principles governing a life insurance trust are much the same as those governing other trusts, and that subject will be discussed at greater length in a subsequent chapter.

Different insurance companies naturally have their own ways of doing business and may not all offer precisely the options described. These are fairly typical, however, and if one of them is not offered by a company, something closely approximating it will probably be found to be available. In selecting an insurance company, the rates used in and the participation features of the optional settlements of the leading companies may well be considered.

Chapter Five

MAKING A WILL

WITH the exception of providing adequate life insurance, making a will is the most important financial duty one owes to those dependent on him. The fact should be self-evident, but the very large number of people of substantial means who die intestate, and the great proportion of wills made under the very circumstances most likely to result in their invalidation, establish beyond question that the necessity of making a will and the importance of doing it properly are far from being generally recognized.

This is not, perhaps, difficult to understand. Many people fail to make wills on the mistaken theory that in the absence of a will their property will go to their dependents just about as they would wish it to go, while a great many carelessly drawn wills result from failure to realize that even though a will is not contested, it will not

be admitted to probate unless it satisfies legal requirements.*

A will is a unique instrument. When it takes effect, the maker is dead and is not available either to give testimony or to explain his meaning. For this reason, and because one only has such right to dispose of his possessions after death as the state gives him, a will, to be accepted, must conform to the requirements of law. When a will is offered for probate, it must be affirmatively established before the court having jurisdiction in such matters that the statutory formalities have been met. The only safe procedure in making a will, therefore, is to have it drafted by a competent attorney. A person familiar with the laws of

* Just as this was being written, on May 17, the following item, fairly typical of probate court news, appeared in that day's issue of the *New York Times:*

"Ruling that the will of the late Charles Horace Rathbone, Jr., former artist in this city, was not executed in accordance with the laws of this State, Surrogate James A. Foley granted letters of administration yesterday to the widow, Mrs. Martha Moore Rathbone of 75 Central Park West.

"Mr. Rathbone, who was known for his sea pictures, died on Feb. 22 at Miami Beach, Fla. The estate was valued at $10,000. A son, Charles Horace Rathbone, 3d, was the only other heir named in the petition.

"Surrogate Foley refused probate of the will, dated Jan. 7, 1936, because it bore the name of only one witness."

his state may perhaps execute a very simple will without consulting an attorney, but even in such a case, the risk of having it refused probate because of some technicality far outweighs the small savings effected.

The laws of different states bearing on the disposition of property of people who die intestate vary. Many of the injustices and absurdities which formerly existed have been remedied in recent years by legislation, but it is safe to say that even now the chances are greatly against anyone's property being distributed by the state exactly as the owner would have wished, and in many cases, an intestate's property is undoubtedly disposed of in just the way he would least have desired. To toil, to save, to accumulate an estate, and then to leave it for the state to distribute is surely about as foolish a thing as one can do. Probably nearly everyone who dies without leaving a will had the intention of making one but put it off too long. A person should make his will just as soon as he is old enough to do so and owns anything of substantial value.

The subject of wills is highly technical and legalistic, but a little knowledge of it is scarcely as dangerous as none at all. A brief discussion of the principal points to bear in mind may be useful to the layman, if for no other purpose than to emphasize the very great number of complica-

tions and difficulties which may arise and the advisability of obtaining expert advice in performing this very important act.

The admission of a will to probate, which means in effect its acceptance by the state having jurisdiction, rests principally on its meeting the following conditions:

1. It must be made in the form and manner and under the conditions provided by the laws of the state having jurisdiction.

2. The maker must be competent, that is, of legal age, sound mind, and acting of his own volition, free from duress or undue influence.

3. The subject matter must be understandable.

The first condition is usually easy enough to fulfill, as in most states the specific legislative requirements are fairly simple. In New York, a will must be dated and signed by the maker at the end; it must be witnessed by at least two persons who see the maker's signature affixed; and it must be declared by the maker in the presence of the witnesses to be his will. If a will does not meet these conditions, it is simply refused probate and is entirely inoperative. The will may of course be signed by mark, and, if the maker is incapable of affixing his signature, he can authorize someone else to do it for him. There are no particular requirements as to witnesses,

but they should be carefully chosen so as to dispel any possible indication of fraud or undue influence. Certainly the witnesses should not be among those named as beneficiaries of the will. Preferably, they should know the maker of the will personally, and the better they know him, the more valuable their testimony will be if any question arises when the will is submitted to probate. They should be of good character and, preferably, of some standing. The witnesses must sign a statement that the testator declared the document to be his will and that he signed it in their presence. It is advisable, in case they may not be available when the will is probated, that the testimonium include a statement that the maker appeared to be in full possession of his faculties and to be signing the will of his own volition.

Of course, when all of a person's real property is located in the state in which he resides when he dies, no question of jurisdiction arises, but that is not always the case, and if not, it is very important that the will conform to the laws of all the states which may be involved. It has usually been held that the disposition of realty is governed by the laws of the state in which it is situated, and a will bequeathing real estate intact must be made in accordance with the laws of all states wherein it is located. Under the doctrine of

conversion, however, if a will provides that realty is to be sold, it is considered as personalty, and its disposition, like that of other personalty, is generally governed by the laws of the state in which the testator last resided. It is important, therefore, for one moving from one state to another to make sure that his will conforms to the laws of the latter.

There may be in any state particular statutes bearing on wills, the violation of which may make the entire instrument invalid. An instance is the New York law forbidding one with close relatives to leave more than half his estate in the form of charitable bequests. Exact knowledge of the law is essential in drawing wills.

The question of competence is, of course, a very technical one, but it may be possible to set forth some general principles which will at least serve to prevent a will's being made in such a way as to invite invalidation for lack of competence. In the first place, the maker must be of legal age. This varies in different states. In a particular state it may be different for men than for women, and may be different for real estate than for personalty. Twenty-one is the usual age for males, and either eighteen or twenty-one for women, if real estate is involved, but in some states younger persons of both sexes are empowered to transfer personalty.

The second requirement of competence is that the maker shall be of sound mind, and, as everyone knows, wills are frequently contested on the basis of alleged insanity, senility, feeblemindedness, or undue influence. The courts have usually held that the testator is of sound mind if he is capable of understanding the consequences of the act performed. Consequently, one might be competent to make a very simple will, while incompetent to make a very complicated one. It is usually held that the maker must remember, to a reasonable degree, of what his estate consists, and that he must also have in mind the persons who by fairly close relationship or otherwise would normally be considered to have some claim upon his affections and generosity. Thus, if a will attempts to enumerate the testator's assets and important ones are left out, the will may be defeated. Likewise, if he fails to make provision for near relatives without any rational explanation, it may be inoperative. Consequently, one should, if disinheriting near relatives, mention them and explain why they are not provided for.

Wills made on the death bed or when the maker is ill or very old, and wills made hastily, are somewhat frowned upon and are vulnerable to attack. To be sure, a will made at the very doors of death and in the utmost haste may, if it

fulfills the legal requirements and is not contested, become fully operative; but anyone making a will under such circumstances as these is taking a great chance that it will not be sustained. Everyone should make his will when he is in good health and full possession of his faculties, and should have it in his possession and study it, or at least have the opportunity of doing so, before signing it.

The question of duress or undue influence is perhaps even more technical and less susceptible of positive statements than that of sound mentality. To avoid the possibility of his will's being contested on this ground, the testator should, as far as possible, avoid discussing it with those named as beneficiaries or preparing it with their help. If some person who would generally be considered to have little claim on the maker's affection is named as a principal beneficiary, a rational explanation should be given in the will. After the will has been made, it should be kept by the testator with his valuable papers, or be left in the custody of his attorney. It should not be delivered to one of the beneficiaries.

If the court having jurisdiction cannot make out the purport of a will, it must, of course, be refused probate. Generally, a court will endeavor to make out from the terms of the will what the maker's intentions were; if they can be made

out in part and it is practicable to do so, that part of the will will be validated and the remainder invalidated. A great many questions arise in the probating of wills in connection with children born or properties acquired after the wills are made. It is generally unwise, therefore, to mention children by name in a will, unless it be necessary for specific or pecuniary bequests, and the will should make it plain that not only the children in being, but children who may later be born, are to be included. If there are adopted children or half-children, they should be specifically mentioned by name or class. Similarly, specific properties should not be described, unless they are specifically devised, and, in this case, too, it should be made plain that the will as written provides for after-acquired properties.

Some trouble has arisen because of alterations, interlineations, and erasures in wills, and it is advisable to avoid such things entirely. If a change must be made, it is worth the trouble to have the will redrafted. The witnesses are required only to see the will signed. They very often do not see it or read it. They cannot testify as to whether the alterations were in the will when it was signed or were made subsequently.

Aside from meeting all legal requirements, one must take care that his will is so framed as to dispose of his property in accordance with his

wishes. This is usually easy enough if the terms of the document are simple, but testaments of an involved nature sometimes fail to accomplish the purposes for which they were intended because of either faulty expression or a failure properly to allow for shrinkage in the value of the estate. The first step in making a will is a careful appraisal of the entire estate, including insurance, and estimation of the probable shrinkage from death duties, administration, and other expenses incidental to death. Provision for meeting such expenses must be made, and life insurance offers the best means of doing so. This having been done, there are of course any number of ways of disposing of the estate. Specific and pecuniary bequests may be made, or the entire property may be bequeathed by shares or percentages. Bequests may be made outright or in the form of life incomes and remainders. If large sums are involved, the same considerations as in the case of life insurance make it wise in many cases to provide income rather than outright bequests. Doing so involves the appointment of a trustee, and that subject will be considered in connection with trusts generally.

A bequest which provides that the income from a certain property shall be paid to one person during his or her lifetime, the property

itself to pass thereafter to another person, may cause difficulty if the first legatee survives the other, and any such bequests should be very carefully drawn.

Ordinarily, taxes are levied against the entire estate and are charged pro rata against all bequests, specific and otherwise. If one wants particular bequests to be undiminished, the will should so state and provide for the payment of taxes from the residuary estate. If one's property depreciates in value, or if estate taxes are substantially increased, specific and pecuniary bequests may take up a greater proportion of the entire value of the estate than had been intended, and this matter should be considered when the will is reviewed from time to time.

A person may, of course, leave contingent or conditional bequests, and if he appoints a trustee, he may empower the trustee to decide finally whether or not the conditions have been met or indeed may authorize such payments to specified beneficiaries as the trustee may deem wise. If payments from the estate are to be made to children, the will should appoint either a trustee or a guardian, and, for various reasons, a trustee appointment is usually the preferable course.

It is wise for one who makes a will to review it periodically, and whenever events occur which might have some bearing on any of its clauses,

in order to add codicils or to substitute a new will, if either course is found to be necessary. When two wills are in existence, they may both be held valid, if not in conflict with each other. When a codicil is added to a will, the same formalities must be observed as in making a will. It goes without saying that anyone who has made a will should review it if he marries or is divorced. Ordinarily, it is held that if a man has had two or more wives, property left to one simply designated as his wife or widow will go to the person to whom he was married when the will was made. A man might, therefore, make a will, be divorced, remarry, and die, with the result of having all or the major part of his estate go to the divorced wife.

Every will should appoint an executor. If this is not done, an administrator will be appointed by the court having jurisdiction. It is the general practice in such a case to name the nearest of kin in that capacity. It is highly probable that the one named on this basis will prove quite unfitted by experience or training to administer the estate wisely and economically. The executor named should, preferably, have already acted in such a capacity, and if the estate is a substantial one, the wisest course is usually to nominate a corporate fiduciary. Such an institution is particularly well qualified by its continuing existence, wide experience, and

large resources. The appointment of a coexecutor is unnecessary and usually inadvisable, as it entails additional expense and may lead to delays and disputes. Officers of corporate fiduciaries acting as executors are always glad to confer with beneficiaries. The executor is, of course, entitled to reasonable compensation, usually not more than 5 per cent of the value of the estate, and much less in the case of large estates. If the same executor is also made trustee, he acts in two separate capacities and receives separate compensation for each.

Before concluding this necessarily brief discussion of wills, it may be well to re-emphasize the extreme importance of the subject. One reads of contests over wills involving large fortunes without realizing the very large number of wills disposing of only moderate sums which are disputed. By their very nature, wills are particularly vulnerable to attack. Their makers cannot defend them, and the beneficiaries are, of course, interested parties. Too often wills are contested by relatives whose only interest in the decedents was a hope that they might not linger too long in this world. The testator is the only one who can forestall these possibilities. The man who fails to make a will or does it carelessly may inflict irreparable injury on those entitled to his greatest consideration.

Chapter Six

THE EMERGENCY FUND

THE desirability of having in quickly available form a fund to draw upon in case of unexpected demands is too obvious to require comment. The accumulation of such a fund should be the next step in a financial program after adequate life insurance has been taken out and, for that matter, may well be begun at least during the period in which the insurance is being purchased. The amount required depends entirely on individual circumstances, but liquid resources of a thousand dollars could hardly be judged excessive for anyone planning a definite financial program.

A savings account usually offers the most desirable medium for the fund. It yields a return, and can be drawn upon easily, but not too easily. One who ordinarily carries a substantial checking account may not need a separate savings account, but there is always the danger that when the real emergency comes, the checking account will be abnormally low, and even for

a person of ample means, a substantial savings account is a comforting and reassuring asset.

Whether the account should be in the name of the head of the family or of his wife or of the two jointly depends on circumstances. Each plan has advantages and disadvantages. In some cases, the best solution is to have two accounts, one solely under the control of the husband, the other under that of the wife. The latter is likely to be the one that is intact when the genuine emergency arises.

Deposits in national banks and most others are insured up to $5,000 by the Federal Deposit Insurance Corporation, an instrumentality of the national government. Whatever one may think of the essential soundness of this scheme, it will, while in force, give enough safety to satisfy the average person, and the depositor without special knowledge should, if possible, use a bank which is a member of the Corporation. An exception should be made, perhaps, in favor of those New York City savings banks which have formed their own mutual assistance institution and of other mutual savings banks which have followed a similar course. If the Deposit Insurance Law is repealed, ample advance notice is certain to be given. It has not, however, been tested in the courts, and if it is declared unconstitutional, the guaranty will be-

come void immediately, although the government may endeavor to substitute some other form of protection. Aside from the possibility of the law's being declared unconstitutional, an emergency fund tied up, albeit temporarily, in a suspended bank, ceases to fulfill its purpose, and the depositor should try to select a bank in whose inherent strength he can have confidence. Very few bank statements disclose enough information to enable even the expert to appraise them, and the ordinary depositor must depend on a bank's reputation and record. One which has gone through the recent troubled years without difficulty has passed a pretty severe test. Other things being equal, the older the institution, the better, and size is another factor to be considered. There are, of course, some items in a bank statement which may indicate weakness, such as an unduly large amount of real estate, a small amount of cash in proportion to deposits, or borrowed money. In New York and New England, the record of the mutual savings banks has on the whole been such as to inspire confidence. In other parts of the country, most commercial banks have savings departments, kept entirely separate from their commercial accounts.

The only sensible way to build up a savings account is by regular weekly or monthly deposits,

supplemented, possibly, by what may be called windfall deposits from unexpected accessions to regular income. In addition to serving as an emergency fund, the savings account is often the source of investment funds. When it becomes larger than necessary, money is withdrawn for the purchase of a home, securities, annuities, and the like.

Reference has already been made to the possibility of allowing dividends on insurance policies to accumulate at interest. If this is done, a larger rate of interest is obtained than is paid by most savings banks. Such funds may be withdrawn without much delay, but a reasonable period must be allowed for the request to be sent to the company's home office, the data collected, interest figured, and a check drawn and sent to the policyholder. A fund of this sort is not, therefore, as promptly available as a savings bank account but may be considered as a sort of secondary reserve.

Situations arise, of course, for which even savings accounts which might have been expected to prove ample fail to suffice. One emergency may succeed another, or one's income may be sharply diminished or cease altogether for a protracted period. Resort must then be had to borrowing, and bonds constitute the most desirable collateral for loans. The higher grade they

are, the better, since the danger in borrowing on securities lies in the fact that a fall in their value may reduce the margin to such an extent that unless more margin is put up the securities must be sold, and the more stable the value of the securities, the less likelihood there is of this happening. By the same reasoning, it is better to borrow on short-term bonds than on those of longer maturity. For small amounts, U.S. Treasury Bonds of low denominations offer an attractive combination of safety, a substantial if small yield, and acceptability as collateral for loans.

Borrowing on life insurance should be the last resort. The reasons for this should be obvious but bear emphasis because the ease of obtaining life insurance loans makes this means of raising money superficially attractive.

In the first place, life insurance is set up not for the insured's benefit, but for the protection of dependents, and borrowing on it not only reduces but may ultimately endanger that protection. It has been said that any one who borrows on life insurance borrows from his dependents. In actual fact, the great majority of such loans are never repaid in cash and, in the end, are deducted from settlements. There is no compulsion or pressure to pay either the loan or the interest on it. So the loan grows at compound interest. Despite the absolute safety of policy loans as investments

for insurance companies, the administrative cost is high because of the small average amounts of such borrowings, and a relatively high rate of interest, generally 6 per cent, is charged.

Indeed, if one has reached the point where money must be borrowed on life insurance, consideration should be given to borrowing at a bank rather than from the insurance company. If prevailing interest rates are low, there may be a substantial saving through that procedure, and the bank will endeavor to collect interest and to have the loan paid off. Borrowing on life insurance in this manner involves assigning the policy to the bank and the form of assignment is important. Some banks seek to have assignments so drawn as to cover not only the loans being negotiated but all other obligations already existent or subsequently incurred. It is to the interest of the insured and the beneficiary to avoid such all-inclusive assignments. The assignment should be limited and should indicate by its terms that it is for the purpose of providing loan collateral. The insured should make certain that the balance remaining after the bank loan has been satisfied will be paid directly to the beneficiary, either by the insurance company or the bank, preferably the former, if that can be arranged.

Chapter Seven

ANNUITIES

After adequate life insurance and a suitable emergency fund have been provided, the next step in a plan for security is to make provision for old age. It may be that that part of the estate intended primarily for this purpose may be put to other uses, or that it will not be required and will be passed on to heirs, but old age, or retirement from active work, is a contingency which should be kept definitely in mind.

One has a choice of three general ways in which to create an estate for this purpose: managing one's own savings, conveying funds to a trustee, or buying annuities—or, of course, any combination of the three. The first two methods will be discussed in subsequent sections, and the third method, annuities, forms the subject of this one.

What is most commonly meant by annuity is a guaranteed income beginning either at an agreed date or upon the death of one person and lasting as long as the annuitant lives. The term "limited annuity" is sometimes applied to what

we have referred to, and what is most generally known as an installment contract, but for purposes of clarity, we shall use annuity only in connection with an arrangement under which payments do not cease before the annuitant's death.

In some respects, an annuity is the reverse of a life insurance policy in that while under the latter payments are usually made to the company as long as the insured lives, under the former they are usually made by the life insurance company for as long as the annuitant lives. The same factors, however, decide the rates at which they are sold—mortality tables, expected investment return, and expense loading. The last element is not a relatively important one in the case of annuities. Moreover, as we have seen, people nowadays live much longer than they did when the life insurance mortality tables were constructed, and life insurance companies would lose tremendous sums if they sold annuities on the basis of these tables. Entirely different tables are therefore used, but, even so, annuitants live longer on the average than these special tables provide for, with the result that the insurance companies make no profit from this factor. Nearly all companies now assume a 3 per cent interest rate, and while their average earnings over a long period of years have been much higher than that, they

have steadily decreased for the last few years. Most companies do not write participating annuity contracts unless the annuity is combined in some way with life insurance or with an installment settlement contract. Insofar as life insurance may enter into a policy, dividends are usually paid by the mutual companies, and most of them at least make extra payments in connection with the installment features of annuities if income from their investments is larger than than that assumed in calculating rates.

A great many different kinds of annuity contracts and contracts including annuities are offered. They may best be classified in four ways: first, according to the frequency of payment; second, according to the manner in which the consideration for the annuity is paid; third, according to the time at which payments to the annuitant begin; and, fourth, according to the inclusion or exclusion of a guaranteed number or amount of payments.

Either annual, semi-annual, quarterly, or monthly payments may usually be arranged. The shorter the period, the smaller the annuity is for a given principal. This is because of the larger expense occasioned by more frequent payments and the fact that since payments are made until the annuitant dies, the company may have to make more than twice as many semi-annual

payments, for instance, as it would annual payments. The chance of the annuitant's receiving a greater amount under one method than another is just about equal to his chance of receiving less, and the annuitant's convenience should be the paramount consideration in deciding on the periodicity of payments.

The next classification relates to the manner in which the consideration is paid, either in a single stipulated sum, or in equal periodic payments for a stated number of years or until the annuitant reaches an agreed age. The single payment may be in cash or may result from the use of the proceeds of an insurance policy. (At least some companies offer a larger return in the latter case than in the former.) Annuities purchased outright are particularly suited for elderly people who have saved or otherwise acquired substantial sums of money, and who wish to derive the largest possible benefit from them for themselves. A man and his wife may purchase a joint and survivorship annuity, payable as long as either lives, or they can each buy a single annuity, thereby securing a larger income while they are both alive. A man of relatively small means may make certain provision for a single dependent, such as wife or parent, at relatively small cost by buying a reversionary annuity, either in one sum or through installments, under

which there will be no return if the beneficiary dies before him, but which will assure the beneficiary an income for as long as the latter may survive him. Annuity contracts also provide a desirable means of making gifts to relatives or others who might not make good use of substantial sums of money, and of taking care of employees who have earned pensions.

When a person begins in youth or middle age to provide for his own old age or retirement, one of the best means of doing so is to take out an annuity on the basis of a definite premium payable regularly until the age is reached at which payments to the annuitant are to begin. Another method of providing for old age, particularly appropriate for anyone with a highly fluctuating income, is to buy a single payment annuity whenever sufficient funds are available, payments to the annuitant under all of the contracts to begin at a stipulated age.

Many companies offer a contract known as "retirement income," paid for over a period of years, providing a definite amount of insurance up to the stated retirement age, usually fifty-five, sixty, or sixty-five, and an annuity to the insured if he survives that age, with a certain number of payments guaranteed. Loan and cash surrender values are guaranteed, and the policy is usually participating. The annuity is naturally smaller

than under a straight deferred annuity purchased for the same premium. The retirement income policy is particularly well suited to a person whose life insurance is inadequate at the time he begins making provision for his own old age.

Annuities are classified according to the time payments begin, as either immediate or deferred. The first payment under what is known somewhat inaccurately as an "immediate annuity" is usually paid one interval after the annuity is purchased, a year if payments are to be made annually, and so on, but arrangements may be made to have payments begin at any particular date desired within that period. When the annuity is paid for by a series of periodic payments, it is always considered a deferred annuity, and one paid for in a single payment may be deferred. Usually, an annuity paid for in installments becomes payable when the installments are completed, but this is not invariably so. For instance, one may pay annually until age sixty on an annuity becoming payable at age seventy. The deferment may be of any period which will end before the annuitant becomes too old. A person may thus pay in a single sum at age twenty, in purchase of an annuity beginning at age sixty. The interest accumulation is very large in such a case, and each annuity payment constitutes a large percentage of the original sum paid in.

The final classification of annuity contracts relates to the inclusion of any guaranteed payments. A straight annuity carries no guaranty except payment throughout the remaining life of the annuitant. If the latter dies soon after payments begin or even before they begin, the contract is terminated, and little or nothing is paid out by the insurance company. Of course, if the annuitant lives to a very old age, much more is paid out than the purchase price and interest accumulations. To prevent the possibility of inadequate return, annuities are offered under which the company guarantees either to make a stated number of payments or to pay out at least as much as the purchase price. Most deferred annuity contracts include some guaranty, usually of the return of the sum paid in, and many insurance companies now refuse to issue any deferred annuities except on such a basis. The method of constructing an annuity contract which includes a guaranty is to combine an installment contract covering the guaranteed payments with a deferred annuity beginning at their conclusion. If the annuitant dies before the guaranteed payments have been made, the unpaid balance is paid to the annuitant's estate or to designated contingent beneficiaries. The commuted value of the future payments may be paid in one sum, or the payments

may be continued until the guaranty has been fulfilled.

A straight annuity, of course, costs less than one of the same amount which includes a guaranty as to number of payments or return of the amount paid in. The difference in cost is not very great for annuities payable at the younger ages, but increases with the payable age and is quite large at the older ages. Whether a straight or a guaranteed annuity should be chosen in a particular case depends in large measure on whether or not the annuitant's death will leave dependents not otherwise provided for. Usually, if one has children who may not be self-supporting when the annuity becomes payable, a guaranty is desirable. Of course, the amount needed as income for the annuitant may be the controlling consideration. An elderly person wanting to be assured of an adequate life income, but also desirous of providing for heirs, may find it advisable to buy a straight annuity and make outright gifts to the heirs, rather than to use all the funds available for an annuity with the return of the purchase price guaranteed, for if the latter course is followed, the heirs may receive nothing at all.

The great variety of annuity contracts available and the many different situations for which they are particularly suitable have been sufficiently indicated.

The feature of an annuity which makes it so particularly well suited to old age provision in general is the large annual income in proportion to the purchase price. The older one gets, the higher the return, of course, and, if one is very old when payments begin, the return is very high indeed, as much as around 17 per cent at age eighty. As the life expectancy of a woman is greater than that of a man of the same age, a given amount will purchase a substantially greater annuity for a man than for a woman, the difference increasing with advancing age. Even at the ordinary retirement ages, fifty-five, sixty, and sixty-five, a much higher annual income can be secured from an annuity than from any safe investment. There is certainly no other means by which anyone can provide for old age as safely and at as small an expense as by annuities. As already indicated, a person with a fairly stable income can, by paying a relatively small amount annually during the earning years, secure a generous annuity for retirement. Even at the younger ages, annuities give larger incomes at the present time than do really safe investments, such as government bonds.

There is certainly nothing more secure than an annuity in one of the old, well-managed life insurance companies. The strength of the life insurance business and the factors to consider in choosing a company have already been dis-

cussed, but it is particularly important in the case of annuities that an unquestionably sound company be selected. A company with small resources, selling a large amount of annuities in proportion to its life insurance business, might be embarrassed by mortality losses on the annuity end of its business. Among the old, large companies, annuities form too small a proportion of their total business to cause any concern. In selecting a particular company, the situation is quite different for one buying life insurance the proceeds of which are to be paid as an annuity, than for one buying an annuity either in a single payment or installments. In the first case, the cost of the life insurance is the important factor, and the company should be chosen on that basis. In the second case, the annuity rates quoted by the different companies, the participation features they offer under these contracts, if any, and the actual yields should be considered. The factors which may enable a company to sell low-cost life insurance do not necessarily lead to high annuity returns. Some of the large mutual companies have recently undertaken the sale of participating annuities, and experience thus far indicates that the returns under these contracts are greater than under the non-participating contracts sold by most companies. The thing for the annuity buyer to do

is to decide just what type of contract best suits his needs and then buy it from the company which appears to offer the highest return of those in which he can have full confidence.

Aside from the great advantage of a high annual return, the annuity, of course, is a definite, certain investment. Once the necessary payments have been provided, there are no further worries. The risks and difficulties of investment will appear in subsequent chapters, and it will be later seen that creating trusts by no means eliminates risk. The freedom from care and worry provided by annuities is one of their strongest attractions. It is maintained by a great many insurance men that the long average life of annuitants is attributable in no small measure to this feature of these contracts.

The question of the extent to which annuity contracts are subject to creditors' claims is too involved to permit of any very definite statements. Ordinarily, an annuity purchased in good faith by one person for another is exempt from such claims, but, if one buys an annuity for himself, the payments may, in some states at least, be attached as they become due. The cash value of a retirement income policy is usually subject to claims against the owner.

Chapter Eight

TRUSTS

A trust, in the ordinary sense, involves the conveying of property by the grantor to the trustee, to be managed by the latter for the benefit of the grantor or other designated beneficiaries or both, under conditions set forth by the grantor in the contract, known as a deed of trust, and accepted by the trustee. Reference has already been made to life insurance trusts. The distinguishing characteristic of a living trust is that the property is conveyed to and managed by the trustee during the life of the grantor. A trust under will is what the term implies. The general principles governing all three are much the same.

One or more individuals or a corporation with trust powers, usually a bank or a trust company, may be designated to act as trustee, or the corporation may be jointly nominated with an individual or individuals. It is generally advisable to name a corporate trustee because of its continuing existence, its responsibility, the

experience and ability of its staff, its legal and financial resources, and its freedom from personal influences, as well as because its future business depends on its reputation for managing trusts capably. The members of its staff handling a particular trust can familiarize themselves with the affairs of the beneficiaries and give them due consideration as well as could personal trustees, while at the same time they can take refuge in the corporate structure from personal pleas which it would be unwise or contrary to the spirit of the trust agreement to entertain.

The practice of naming a bank or trust company jointly with a personal trustee cannot be generally recommended. It may lead to disagreements and delays. The personal trustee may be unavailable when his consent is required to an action which should be taken at once. Exception may be made in the case of an attorney or businessman of wide experience who knows the beneficiaries, but the common practice of naming a beneficiary as cotrustee has not as a rule proved highly satisfactory. In general, the grantor should carefully select the trust company or bank, draw up the deed of trust as wisely as possible, and let it go at that.

It is usually advisable, if not absolutely necessary, to name as trustee an institution located in the city in which the beneficiaries

reside, or at least within convenient distance of them. If the trustee has any discretion in making payments, the trust officer should keep closely in touch with the beneficiaries and familiarize himself with their circumstances and problems. Moreover, the personal service which often adds greatly to the value of a trust relationship can be performed only when the trustee and the beneficiary are near each other.

A trustee is entitled to reasonable compensation for services performed, and to avoid disputes and misunderstandings, it is advisable to incorporate the agreed rate in the trust deed. In some states, at least, trustee fees are limited by law. It is usual for a trust company to charge a percentage, not over 5 per cent, of the principal sum administered, and another percentage, not over 5 per cent, of the annual income. Smaller percentages are usually charged if the trust estates are of great value. The charge is not usually reduced by the appointment of a co-trustee, who is of course also entitled to compensation.

There are no particular limitations on the kinds of property which may be trusteed, but ordinarily the corpus consists of cash, securities, real estate, and insurance. Usually a corporate trustee does not seek trusts involving inconsiderable sums, but there is no general limitation,

and in particular situations very small trusts are created. Someone, as often happens, may draw a will when the estate is small, anticipating its growth, and trust companies are generally glad to be named under these circumstances. A living trust, also, may be created under much the same conditions. Life insurance is not often trusteed in smaller amounts than $10,000, but there are many exceptions, particularly when minors are designated as the beneficiaries.

In managing a trust, the trustee is first bound to abide by the terms of the deed. He is also required to use due diligence in protecting the interests of the beneficiaries. Good intentions are not enough and will not excuse failure to take such action as a prudent person might be expected to take. In making investments, a trustee is limited to such investments as may be prescribed for trust funds in the particular state, unless the deed of trust specifically waives those restrictions.

The discretion the trustee may exercise depends entirely on the conditions of the trust, and the grantor should give very careful thought to this matter. He may direct, for instance, that investments be confined to particular classes of bonds, such as government bonds, or to bonds of a particular rating, or to bonds, preferred stocks, and mortgage loans. He may give the trustee en-

tire discretion or he may specify that investments up to a certain amount or up to a certain proportion of the entire estate may at any one time be invested in common stocks, and he may further limit common stock selections to particular categories or to particular stocks.

It should be emphasized that a trust does not provide any greater safety than legal restrictions or those incorporated in the trust deed, plus the good judgment of the trustee, provide. If the trustee restricted to "legals" buys some bonds of that class which turn out badly, it cannot be held accountable. If empowered to buy stocks, it is not responsible for losses incurred so long as it conforms to the terms of the trust. Of course, due diligence is required, and a court might hold a trustee liable if it had purchased securities which a reasonably intelligent person would have avoided, or if its purchases had not shown a due regard for such fundamental investment principles as diversification. Similarly, a trustee must act exclusively in the interests of a beneficiary and may be held liable for the purchase of securities with any ulterior object, such as putting up the price of a stock in which the trust officer is personally interested. The purchase of a security in which an affiliate of the trustee corporation was interested might constitute a cause of action. But, a trustee is not supposed to possess infallible

judgment. Unless, therefore, a trustee is limited by the deed to the most conservative securities, such as United States bonds, there is necessarily at least a moderate degree of risk in any trust.

It should quickly be added, however, that a corporate trustee is much better fitted by experience, investment knowledge, and access to sources of information to invest funds than is the average individual. In all probability, an estate managed by such a trustee will suffer less depreciation than it would if so managed by the beneficiary as to yield the same income. In either case, the higher the yield, the greater the risk, insofar as fixed income securities are concerned, and of course, if equities are included, a still greater risk is incurred. It is up to the grantor to determine the general investment policy to be followed, and there is no valid cause of complaint if the trustee follows that policy and losses ensue. If no investment conditions are set forth in the deed of trust, the investment policy in most states is that prescribed by law for trustees, and while trustees are limited specificially or inferentially to classes of investments generally regarded as conservative, depreciation may nevertheless occur.

The degree of discretion which should be permitted in making investments depends entirely on the circumstances. If safety is wanted

above everything else, only the purchase of United States and possibly certain state bonds should be authorized. If a higher yield is desired and the estate is large enough to permit of adequate diversification, greater latitude should be given, and as the trustees are usually selected because of their experience and ability in investment matters, it is generally advisable not to confine them too closely. So-called "legals," for instance, have a somewhat artificial demand, created by their inclusion in that class, and may yield less than equally safe securities not admitted to the lists. In the case of a living trust, the grantor may be absent from the city or incapacitated when a decision should be made, and restrictions might prevent action which would be very advantageous. If a trustee is acting under will, investment conditions may change and the trustee should not be prevented from adapting the trust to the new conditions. The general investment policy, in short, should be determined by the grantor, and the trustee should be allowed to use his judgment in carrying it out. In the case of a living trust, the grantor may stipulate that only such investments are to be made as he directs, or he may, by appointing himself co-trustee, participate in the management of the estate.

Corporate trustees sometimes fail, but ordi-

narily their trusts do not thereby suffer. Trusts are surrounded by a great deal of protective legislation. They must be kept separate from the general funds of the trustee and from each other. They are not subject to claims against the trustee. If the latter becomes insolvent, the trust funds are simply administered by the receiver and eventually find lodgment under court order with a succeeding trustee. The only possible exception to this rule consists of cash deposited in the trustee's banking department, and the actual danger of a trust's suffering loss in this situation is very small. Such a deposit in a national bank must be protected by bonds deposited with the Trust Department, and deposits of this kind in state banks are prohibited in some states and safeguarded in various ways in others.

Unless specific authority is given in the trust deed to commingle the funds with those of other trusts, they must be kept separate. When so commingled, of course, greater diversification of investments is possible for small trusts, but another result is that the grantor no longer controls the investment policy, as he should ordinarily do.

In paying out income and principal, a trustee may use such discretion as the deed authorizes. He may be directed to divide the income between the beneficiaries equally or in stated shares, or,

he may be authorized to pay such amounts as he deems necessary. He may be authorized or forbidden to make payments from principal, and if so authorized, may be limited as to the purposes for which, the extent to which, or the times at which such payments may be made. He may be simply empowered to use his own judgment in the matter. The trustee may be authorized to pay certain expenses in behalf of the beneficiaries, the amount of such payments being left to his discretion or limited in various ways.

Here again, the discretion allowed must depend on the circumstances, but one great advantage of the trust is the latitude it makes possible for meeting changed conditions and particular situations. If the trustee is too narrowly restricted, he may be unable to take some action which the grantor would have heartily approved.

Anyone contemplating the establishment of a trust should decide under just what conditions he wishes it to be managed and should then confer with the prospective trustee and his own attorney. If a bank or a trust company is to be appointed, its own attorneys will be glad to assist the grantor's attorney in drawing up the trust agreement, particularly in seeing to it that the deed of trust authorizes the trustee to do those things which are ordinarily necessary in managing properties, such as giving proxies,

acting in reorganizations, etc., and in making sure that the deed is so drawn as to terminate within the legal period. Most states require that a trust must terminate within twenty-one years after the death of the longest surviving beneficiary who was alive when the trust became effective. A life insurance or testamentary trust, of course, takes effect in this sense when the insured or testator dies.

The extent to which trust estates are exempt from claims by creditors is a legal matter and, as the laws in the different states vary and may be changed from time to time, this is a subject which should be taken up with an attorney and the trustee. Generally, an irrevocable trust, entirely out of the control of the trustor, is not subject to the claims of the grantor's creditors. If the grantor retains any control, the estate is subject to such claims. Likewise, a trust subject to the control of the beneficiary is subject to claims of the beneficiary's creditors, but if not under the beneficiary's control, is not subject to such claims.

There are almost countless situations in which the creation of a trust is either necessary or desirable. Those which call for life insurance trusts were noted in connection with the disposition of insurance proceeds. A living trust is particularly appropriate if one wishes to be relieved of the troublesome details involved in estate man-

agement. One may convey securities or cash to a trustee and direct that, after the payment of insurance premiums and, perhaps, other bills, the balance of income is to be paid to the grantor or partly to him and partly to other beneficiaries. Collection of interest and maturing or called securities is then assumed by the trustee and the payment of insurance premiums made certain. The general advantages of trustee investment service have already been referred to.

A trust under will must be established if one wishes to leave his estate to heirs in the form of income. The desirability of doing so in the case of a substantial estate has been sufficiently discussed in connection with insurance. Aside from that, a trust under will permits in a sense a continuance of the testator's supervision over the affairs of his heirs. He makes known his general purposes and wishes, and the trustee endeavors to carry them out. In such matters as charitable donations, the education of children, even the choice of their careers, and, of course, the payments to heirs or on their behalf, the trustee is often authorized to give advice or to exercise control. Very often a mutually pleasant relationship exists between a trustee and a beneficiary, and the former's assistance is asked and fully given in matters quite outside the terms of the trust. A gift in the form of income may confer

greater benefits than would the outright conveyance of a large sum of money, and the most satisfactory way to accomplish this is by creation of a trust. A gift trust is also frequently used with a view to reducing or avoiding tax payments, but the general subject of taxes in relation to trusts will be reserved for the chapter dealing with the effect of taxation on a security plan.

One may establish a living trust under the terms of which he will receive the income during his lifetime, the income thereafter, let us say, to go to his widow for her lifetime, the principal to be passed at her death to his children or to other beneficiaries. Such a trust agreement in effect combines to some extent a living trust and a testamentary trust, without a will, and, while there may be theoretical objections to disposing of property after the owner's death without meeting the legal requirements in connection with making a will, a trust agreement of this type is undoubtedly feasible and entails less expense than would separate voluntary and testamentary trusts.

Chapter Nine

BONDS

QUITE justifiably, bonds occupy a very high rank in the field of investment and are particularly well suited to the individual investor. While safety and yield are the most important factors to consider in selecting an investment, there are many other things to take into account, some of which have a direct relation to safety. Stability of value, marketability, availability as collateral, convenience, and the possibility of diversification are among the most important, and in all of them bonds as a class are preeminent. In a security plan, safety is the most important factor, but there is no such thing as an absolutely safe investment. The sensible person will plan his financial program with a view to insuring himself as far as possible against suffering losses out of proportion to the yield he obtains. Safety and yield must be considered together. One who invests at an average yield of 5 per cent can take a small loss and be better off in the long run than if he had obtained a

yield of 4 per cent and had no losses at all, but this principle has practical application for the prudent investor only if he can sufficiently diversify his investments to guard against one bad situation's causing him a heavy loss. Diversification of all kinds is therefore a very important element of safety. Bonds of every conceivable kind, degree of safety, yield, and maturity are available and permit of a well-planned program of selection to a greater extent than does any other form of investment.

This very great variety, however, entails its difficulties. There are so many factors which influence bond values that it is quite impossible for the layman accurately to appraise individual issues. Bond buying has become a highly technical profession. Very large books indeed have been written about bonds, and even a person who is thoroughly posted on all the points to be taken into account in evaluating them is quite helpless unless he is in a position to assemble and analyze large amounts of data. Insurance companies probably have as adequate means of analyzing bonds as have any institutions, and they command the services of very able buyers, but they do not by any means avoid losses. How, then, can an individual intelligently decide whether a particular issue has merit, let alone pick out those issues most suit-

able for his own portfolio? Obviously, the answer is that he can do neither, but fortunately one can, without specialized knowledge, follow a policy of bond buying which will, in most cases, prevent him from incurring any serious losses and yield a return which should compensate for any risks taken.

One who plans to manage his own investments should naturally have a working knowledge of the subject of bonds, including the most common ways in which they are classified, the principal factors affecting each kind, the terms commonly used, and especially the most common dangers to guard against; but before proceeding to such matters, it will be well to consider the even more fundamental things which should guide a layman in planning his general investment program.

There are available bonds of almost every degree of safety or lack of it. Generally speaking, the greater the risk, the greater the yield. Quite obviously, the man who is in no position to suffer any loss should look to safety almost exclusively. One who by dint of saving is able to buy a bond obviously cannot afford to take any chances. He should buy the safest; and the safest bonds are those issued by the United States of America. Unless there is some particular reason to the contrary, the first bond purchase should be of distant maturity, for, ordinarily, the longer the

maturity, the higher the yield. The return on bonds issued by the Federal Government is small, but they are exempt from the normal Federal and all state income taxes, and most investors gain by these exemptions. As the small investor increases his holdings, he should stick to United States bonds until he reaches the point where he can regard a possible loss with equanimity. In subsequent purchases of these bonds, however, he should begin to diversify as to maturity. Prevailing interest rates and the general price level fluctuate quite unpredictably, as we have seen, and if one's investments all mature at the same time, it may turn out that that will prove to be the most disadvantageous time for reinvesting. Diversification of maturity simply tends to assure average luck in this matter. It is a form of security.

When the point is reached where one can diversify enough to insure against an isolated loss too greatly affecting one's resources, it is proper to seek a higher yield than governments afford. Bonds issued by states rank next to those issued by governments in point of safety, but these bonds and those issued by subsidiary governmental units—cities, counties, etc.—are not entirely suitable for the small investor because their exemption from all Federal income taxes, and in most states, at least, from all state income taxes,

makes them extraordinarily attractive to wealthy persons, with the result of making their yields lower than would otherwise be justified. The investor not subject to high income surtaxes, who buys these bonds, pays for something he does not get. Of course, anyone can easily determine what he would save by tax exemption, add it to the yield, and compare the resultant figure with the yields of other high-grade bonds. Certainly, none but an investor with large resources should buy state and municipal bonds, and the important thing for such a one is to diversify his purchases geographically and by maturity.

The small investor seeking a higher yield than United States bonds provide should turn to the corporate list. The yields given by active bonds at their current prices pretty accurately reflect their respective merits, and safety is the greatest merit a bond can have. This is not to say that the yield of a bond is exactly proportionate to the risk. Indeed, one of the most important things for the bond buyer of substantial resources to remember is that yield increases in greater proportion than risk. One buying a thousand diversified long-term bonds on a 5 per cent basis, with governments yielding 3 per cent, would not, if he held all of them to maturity, be likely to suffer total losses as large as the extra income he would receive. This is natural because safety is

such a prime consideration to many investors that it commands a premium. The fact that many institutions and trustees are confined to certain classes of bonds regarded as ultra-conservative is also a contributory factor. This principle is, however, of no use to the small investor. If he buys only a few fairly high-yield bonds, and one defaults, it is no consolation to him that on the average only one in a hundred would default. But the principle is extremely important to the individual investor who can buy a large enough number of bonds to permit adequate diversification. It would be just as foolish for such a person to buy nothing but governments and other extremely low-yield bonds as for the buyer of a few bonds to invest in anything else.

The general principle that the safer the bonds, the lower the yield, and that the difference in yield is greater than the difference in risk, applies only to bonds enjoying an active market. There are, of course, any number of so-called "bonds" peddled among the credulous at prices having no relation to their merits, and even more small local issues, doubtless of high quality, but not enjoying an active enough market to insure that their prices accurately reflect expert opinion of their worth. One can readily determine whether a bond is actively traded in by finding out the bid and asked prices. If they are not far apart.

say within half a point ($5 for a thousand-dollar bond), activity is sufficiently indicated. It is not necessary at all that an issue be a very large one, nor that it be listed on an exchange. Indeed, many issues which are listed are not active, and bonds are more generally bought and sold over the counter than on exchanges. It should be unnecessary to add that the layman without expert knowledge should buy bonds only through banks or dealers of established reputation. If he does so and restricts himself to active issues, he can be pretty sure that the prices he pays reflect all known factors.

When new issues of bonds are offered by responsible houses, one may be fairly sure that the prices are in line with the underwriters' opinions of their values. It is usually better, however, for the small investor to buy bonds which have been outstanding long enough to be tested in the general market.

The sensible program, then, for the individual investor is to confine his early purchases to the most conservative bonds there are; then, as he buys more, to branch out into high-grade bonds with a better yield, and to include fairly high-yield bonds only when he can buy enough to provide complete diversification. He should diversify as to industry, location, and territory, as well as maturity. What appears now to be the

strongest industry or the strongest company may have all sorts of difficulty in the future. There have been too many striking instances of this sort of thing in recent years for the point to require emphasis. For the average investor there are only two roads to adequate safety. One is to buy government bonds and nothing else. The other is to diversify.

Many readers will ask "What, buy bonds without considering earnings, liens, sinking funds, and what not?" Precisely. The average investor may buy active bonds of reputable dealers just as he would without question buy jewels from a reputable dealer. He gets what he pays for, and as long as yield and risk are in proper relation, and he does not so concentrate his investments that a single disaster will do great damage, he need not worry. Of course, just as the jeweler may occasionally recommend an outstanding value, the bond dealer may point out what he considers an investment bargain. Very likely he will be right, but the careful investor will make sure before buying that the bargain fits into his plan of diversification.

There are many bonds which are outright speculations. Some, as we shall see, are of that character from their inception, but a larger number start out as investments and become purely speculative through actual or prospective

default. Whether a holder should sell bonds when their status becomes speculative or questionable is a purely individual matter. If steady income is important, or if the owner is of the worrying type, they should be promptly sold. In any event, the investor with diversified holdings must always bear in mind, when taking losses, that he has already been compensated by the higher yield he has been obtaining.

Bargains in active bonds are exceptional, as the market is quick to appraise all known factors, but opportunities do occur, and the investor with sufficient knowledge may occasionally see the advantages to particular localities, industries, or corporations of actual or probable developments before their effect has been reflected in security prices. If he is sufficiently informed, he may also acquire little-known bonds, perhaps of local companies, at prices out of line with their real merit. Trying to pick up bargains in bonds, however, has its perils, just as in the case of rugs or pictures, and only the really well-informed should attempt it. And here again, any bonds bought on the theory that they are underpriced should never be bought on such a scale as to interfere with real diversification.

While the investor without specialized knowledge can buy bonds along some such lines as those here outlined without risking any very

bad headaches, there is no doubt that a general knowledge of the subject is sometimes useful, if it serves no other purpose than helping him to avoid the common pitfalls. Many bonds are constantly bought without any real understanding of their character. "What's in a name?" might well have been first asked by a bond analyst. First mortgage, general mortgage, first refunding, prior lien, collateral trust—what a wealth of fine-sounding names needy borrowers have at their command! The investor may well ignore the name of a bond entirely and ask himself certain fundamental questions about the issue.

Bonds issued by states and political subdivisions are in most cases simply promises to pay made by governments. Municipalities and the like may be sued and compelled to levy taxes, but most often when a political unit defaults, there is simply no possibility of its collecting sufficient taxes to meet its obligations, and some sacrifice by investors is necessary. The good faith and resources of the borrowers are the things to look to in considering public bonds. What is the fiscal history of the state or the city? Has it always met its obligations? Has it kept its debt in reasonable relation to its resources? What is the character of its population? Is it a settled and conservative community or rather young and

radical? New communities are likely to be over-optimistic about going into debt, and not too scrupulous in meeting their obligations. Are the industries diversified, or is the community largely dependent on one line of business? Is the territory vulnerable to floods, tornadoes, or earthquakes? Are constitutional or charter restrictions on taxes likely to cause difficulties? On what basis are assessments made? Some of these are rather technical questions, and are of importance only if the answers to those about the fiscal history and character of the community are not entirely reassuring. There are countless states, municipalities, and townships in the United States whose high credit is a byword. Considerable caution is advisable, however, in buying public securities that offer tempting yields. Bargains are sometimes available, as in cases where a city's credit may have been injured by the bad records of its neighbors, but such instances are few and far between.

In considering bonds issued by political subdivisions, cities, towns, townships, counties, school districts, irrigation districts, and the like, the indebtedness of all overlapping authorities must be taken into account. Sometimes, five or six of them may cover one area. Bonds issued by public bodies other than the commonly known governmental units require considerable tech-

nical knowledge for proper appraisal, and should usually be purchased by the layman only on the strength of informed and reliable advice. The same is true of assessment bonds, and in every case, the buyer should assure himself that the bond he proposes to buy is the unconditional obligation of the issuing unit.

Corporate bonds are of two general kinds, secured and unsecured. The latter, known as "debentures," are good only so long as the borrowers can pay. Their basis is earning power. If a company which has debentures outstanding cannot earn enough to pay its obligations, its physical plant can rarely be sold for enough to do so. Naturally, a company may have sufficient resources to keep on paying bond interest for some time, while losing money, and may even pay its bonds at maturity under such conditions, but this is done with accumulated earnings. Companies other than railroads and utilities generally use the debenture form of bond, and it is the simplest form to appraise. A company's record of earnings, the relation of its indebtedness to its assets, the stability of its business during depressions, the conservatism of its fiscal record, its size, its freedom from possible governmental interference or regulation, the diversity of its products, and the extent to which demand for them may be considered permanent, are the

principal things to consider. While some of them, particularly assets, may be impossible for the layman to gauge accurately, he can in most cases form a pretty fair idea of the worth of a debenture bond by studying the factors listed.

When an industrial company cannot meet its obligations, one of two things happens. If there appears to be a possibility of the plant's being operated profitably, the company may be reorganized under the direction of committees representing the different interested groups. If profitable operations do not seem possible, the corporation will be wound up and its assets sold. In either case, debenture holders are pretty sure to suffer losses. The important thing to bear in mind, then, about a debenture, is that fundamentally it represents a lien on earnings. An investor is sometimes misled by trusting an apparently strong financial position. He knows, perhaps, that a company, while losing money, owns enough cash and marketable securities to pay its debts, and assumes, therefore, that these are sure to be paid. The trouble is that the cash may be used up in unprofitable operations and that the securities may go the same way. Earnings, and earnings alone, warrant confidence on the part of the debenture holder.

Bonds do not occupy so important a place in the capitalization of industrial corporations as

they do in that of railroads, and, to a less degree, of utilities. The former companies have been built up very largely from earnings and have not required the large initial capital that railroad and utility enterprises have needed. Moreover, they were not publicly financed to any great extent when bond issues were the most popular form of raising money. The monopolistic and essential nature of railroads and utilities has tended to make their bonds seem safer on the whole than industrial issues. Despite the increasing relative importance of industrial corporations, therefore, railroad and utility bonds have continued to dominate the corporate bond field. As railroads and utility companies have merged or affiliated in one way or another, and as successive bond issues have been floated, their capitalization has become complex in the extreme. Secured bonds of one sort and another rather than debentures have been their principal reliance.

The important practical distinction between a debenture and a secured bond lies in the fact that the latter's strength rests not only on earning power, but on the property on which it constitutes a lien. This added factor makes it much more difficult to appraise secured bonds than debentures. Past earnings are a matter of record. The value of a property cannot be de-

termined so easily, and the difficulty is often multiplied by complicated liens which have developed. A bond issue may be a first lien on some property, a second lien on other property, and still a third on something else. Whatever the lien may be, of course, the borrowing corporation which cannot meet all of its obligations must be reorganized, but when that is done, the holders of bonds secured by liens on the important or profitable parts of the system may not suffer any losses, while the holders of less well-secured bonds and of debentures will be forced to make large sacrifices. As a matter of fact, one is forced to the conclusion that secured bonds can be properly appraised only by a specialist with a good deal of statistical data at his command. A general mortgage bond means nothing unless one knows what prior liens there are, and the position of a prior lien cannot be evaluated without knowledge of the strategic position of the mortgaged property. Even such comparatively simple bonds as equipment trusts, secured by rolling stock, present difficulties, for, if a railroad's business is at low ebb, it may possibly be willing to let the bondholders take possession of the cars or engines, while bonds secured by other bonds or stock simply aggravate the investor's difficulties.

In evaluating liens, the layman must depend

either on market valuation or on such expert counsel as he can secure. First of all, he should look to earnings, for no one wants to buy into a prospective reorganization. He should avoid exceedingly complicated financial structures such as characterize some of the large utility systems, for their bonds may represent nothing more than extremely optimistic estimates of future earning power. Finally, he should remember that the railroad industry is just one industry, despite its importance, and that he fails to fulfill the first requirement of prudent investment—diversification—if he concentrates too large a part of his funds in railroad securities, no matter how widely he may scatter his purchases in that one field. The same is true, of course, of the light and power group or of any other.

Before leaving the subject of secured bonds, it may be instructive to point out why the theoretical right of the secured bondholder to take possession of the mortgaged property in the event of default is actually no more than a bargaining or threatening right. When a railroad, for instance, can no longer meet its obligations, there exists a large and complex property, presumably with potential earning power, but with a great variety of claims against it of various degrees of priority. There are also the stockholders, who, theoretically, should not be

entitled to consideration, since debts confessedly cannot be paid, but whose consent to a reorganization plan is necessary. The holders of prior lien bonds on an essential and valuable part of the roadbed cannot actually take possession, even were it possible for them all to act in concert. The railroad is essentially a nondivisible whole. To be sure, certain parts of it may be separable and unimportant, and holders of liens on those parts are not in a strong position as the other interests could say in effect, "Take your properties and make what you can of them." Generally, however, all of the interested groups, including creditors of various sorts, bondholders of different classes, and preferred and common stockholders are simply in the position of having to bargain among themselves through committees as to the terms of a plan—essential to them all—under which the railroad can be reorganized and put in a position to operate profitably. The reorganization must usually reduce fixed charges, postpone immediate maturities, and raise cash. The holders of bonds secured by prior liens on important properties usually suffer no more than postponement of maturity, being recompensed for that, perhaps, by common stock or warrants. The other bondholders receive varying degrees of treatment, depending on their lien position, each possibly receiving bonds for

part of his holdings, stock for the remainder. Preferred stockholders may get common, and the common be assessed. In any event, the individual stockholder has little voice in these affairs and must take what he is given.

Even in buying secured bonds, the investor must place primary emphasis on earning power. What he wants is a bond on which interest will be regularly and promptly paid and which will be retired at maturity. The less he has to concern himself with reorganizations, committees, legal battles, and the like, the better satisfied he will be. In considering past and prospective earning power, he must be on guard against placing too much reliance on general statements. A corporation wants to borrow on the most advantageous terms it can and will naturally present its condition in the most favorable light possible. Such statements as "bond interest earned three times over" may mean very little, despite their very reassuring sound. The issue may be a relatively small one, with the result that three times the interest forms a tiny fraction of the corporation's income. A slight drop in revenue might wipe out the three times bond interest so proudly claimed. The corporation's earning record must be looked at as a whole. Would the company continue to earn bond interest if operations were sharply reduced or costs materially increased? Are earn-

ings applicable to bond interest substantial in relation to total revenues and total earnings?

In the case of any bond issue, the purpose for which the money is being borrowed may be very important. If the proceeds are to be used for expansion into new territories or new lines of business, caution is indicated. Unproved projects entail risk. If bank loans are being funded, the prospective buyer may well stop, look, and listen. If other corporations or properties are being purchased, he should inquire into their value and previous earnings. May the money borrowed be reasonably expected to provide sufficient income for the bond interest long after its maturity, or, if not, enough revenue to cover interest and sinking fund requirements?

Sinking fund agreements and bonds issued in serial form add to the attractiveness of securities in that they provide for the gradual reduction of debt from earnings before dividends on stock can be paid. Of course, if the borrower does not earn enough to meet sinking fund requirements or to retire maturing blocks of serial bonds, it may be forced into a receivership which might otherwise be avoided, but in the long run, no great permanent damage should be done, and the conservative financial policy required by sinking fund covenants and serial issues must be set down as outweighing any possible disadvantages.

A debenture bond is strengthened by a covenant on the part of the borrower that no secured bonds will be issued without the consent of the debenture holders or that if such bonds are issued, the debentures will participate in the lien.

There are, of course, countless factors in bond appraisal, often important in the case of particular issues, which cannot even be enumerated in a book of this scope. Particularly in the case of railroads and utilities, there are many statistical yardsticks which mean a great deal to bond analyst but can scarcely be of much use to the layman. A catalogue of these rather technical terms would be wearying, and of little practical value.

Thus far, the discussion has been confined to bonds in the real sense of the word—obligations with a fixed rate of interest and no trimmings. There are, of course, a great many hybrid securities, called "bonds," but partaking more or less of the nature of equities. Out of reorganizations has come the monstrosity known as the income bond, a definite promise to pay at maturity, but with interest payable only as earned. Then, there are participating bonds, bonds convertible to common stock, and bonds with stock warrants attached. When an investor buys them, he is paying something for the speculative features, though he may not think so. It is diffi-

cult enough to evaluate a bond or a share of stock without endeavoring to appraise a mixture of the two, and it is probably more prudent in most cases for the investor to keep his bond and stock purchases quite separate. An exception may, perhaps, be made in the case of a very sound bond with a profit-participating feature or with stock-purchase warrants attached, selling at an extremely low yield on that account. The investor may be satisfied to accept the low yield, feeling that, for the possibility of future profit, he can well afford to pay the required price in the form of additional income sacrificed. Stock-purchase warrants and profit-participation features are generally more attractive to the conservative investor than are conversion privileges, because exercise of the latter means the loss of the fixed-income security.

The owner of bonds must be careful to figure yield correctly and to treat as income only what may properly be so treated. A bond purchased at par, of course, offers no difficulty, but if one is bought at a premium or a discount, the yield is less or more than the coupon rate. The formulae for computing bond yields are somewhat complicated, and the layman should consult bond tables or his dealer. In the case of distant maturities, one may obtain approximately correct figures by adding to or subtracting from the cou-

pon rate the discount or premium divided by the number of years until maturity. If a bond is callable before maturity at par, the call date should be used if the bond is bought at a premium, the maturity date if at a discount. From the investor's standpoint, callability, even at a premium, is not an advantage. It gives the borrower an option which he can exercise, if that would be to his advantage. In fact, it is a very one-sided arrangement. Moreover, if one owns a large number of callable bonds, they are likely to be called about the same time, when interest rates are abnormally low, thus defeating maturity diversification, the importance of which has already been sufficiently emphasized.

Chapter Ten

PREFERRED STOCKS

SOME preferred stocks constitute an excellent investment medium. They are evidences of limited ownership, without maturity. Unless it is callable by its terms, the only value a share of preferred stock ever has is what it can be sold for—its market price. If continued dividends seem assured, the prices of preferred stocks fluctuate with the general level of interest rates and vice versa. As this is written, dividends are exempt from normal Federal income taxes, but that situation may very possibly be changed in the near future.

Preferred stock is always entitled to payment at par or some other stated amount, often more than par, in the event of the company's dissolution, before anything is paid to common stockholders. The amount payable in the case of voluntary dissolution may differ from that payable if bankruptcy occurs. Except in the case of financial institutions, the provision for involuntary dissolution is not very important, as few

companies forced into bankruptcy and liquidated have much left after all debts have been satisfied.

Most preferred stocks are cumulative, requiring that any passed dividends be paid before any dividends can be paid on the common stock. It is certainly important from the buyer's standpoint that a preferred stock contain this provision, but experience does not indicate that it is as valuable as might be supposed. If a company fails for some time to pay preferred stock dividends, large arrears accumulate and the prospect of paying them off begins to look rather poor. More often than not, the preferred stockholders are asked to accept payment of arrears in stock, and a sufficient number of consents is usually obtained from those holding common stock as well as preferred to make the plan operative.

Preferred stock frequently contains other clauses designed to protect the interest of holders. One of the most common is a provision that, if a certain number of preferred dividends are passed, the preferred stockholders shall exercise some degree of control. Experience does not indicate that such clauses confer any great benefit. All in all, the only preferred stocks which are attractive as investments are those of companies whose records indicate that dividends will be paid continuously in bad times as well as good.

In the last analysis, the merit of a preferred stock depends entirely on earnings. A company's financial record, the stability of its business, and the degree to which its products have an assured future market are the main things to consider. In judging of earnings, the relation of preferred stock dividend requirements to total revenue and to net income are both important. Here, again, it is best to be on guard against reassuring ratios, which may not stand up under analysis. A company should not only earn its preferred dividends by an ample margin, but that margin should be a substantial percentage of gross income.

The relation of preferred stock outstanding to a company's resources, usually given in manuals as equity per share of preferred stock, is not of much value without a detailed analysis of the balance sheet, which the layman is rarely in a position to make. The general financial condition of the corporation, the relation of current assets to current liabilities, the cash position, bank loans, bond issues with near maturity dates, and the like are worth study. They are, however, subsidiary to earnings. If the record of earnings is not entirely reassuring, excellence of other factors cannot compensate. If earnings are largely dependent on patents, their life must be ascertained, and ore reserves are important in the

case of mining companies. So, too, are proved oil reserves for oil producers.

There are many issues of preferred stocks which have speculative features—convertibility into common, profit-sharing provisions, common-stock warrants and the like. What was said of such privileges in the chapter on bonds applies equally in the case of preferred stock. An issue of preferred stock may by its terms be subject to call at a stated price, and in this connection, too, what was written of bonds is just as applicable to preferred stock. From the investor's standpoint, callability is a definite disadvantage. It sometimes happens that callable preferred stock sells at considerably more than the call price, general opinion being that the stock will not be called soon. General opinion may prove wrong, and if so, substantial losses are incurred by those who bought at high prices.

Diversification is just as important in preferred stocks as in bonds, except that the maturity feature is lacking. Concentration in one company, industry, or locality is unwise, and the investor should consider his entire security portfolio in this connection.

Noncallable preferred stocks of high quality appreciate greatly during periods of low-interest rates, because of their perpetual character. Bought at such times, they may have to be sold

at much lower prices. Purchases of these securities at prices giving extremely low yields should, therefore, be avoided.

From the investor's standpoint, the only advantage a preferred stock holds over a bond is its permanence. Unless it is very safe indeed, this advantage becomes a detriment. The matter may be summed up, perhaps, by saying that the relatively small issues of very strong companies without bonded indebtedness are the only preferred stocks which are well suited to the person seeking security. They can be purchased at reasonable prices only when interest rates are high or when all security prices are depressed.

Chapter Eleven

COMMON STOCKS

COMMON stock certificates are evidences of ownership, and ownership of property, except for use, entails financial risk. Where safety of principal and income are the prime considerations, common stocks are not suitable. Since they obviously are not so secure as high-grade bonds and preferred stocks, no one in his senses would purchase them except with a view to appreciation and eventual profit. In short, whether the purchase of common stocks be called investment for profit or investment for appreciation, or, more deceptively, just plain investment, it is necessarily and always speculative. Speculation needs no defense and may properly be included in a sound financial program, provided that the risk is understood and that possible losses can be afforded. It goes without saying that persons dependent on moderate incomes derived from investments should never buy common stocks, and that an intelligent personal security plan should not include ownership of common stocks

until adequate insurance and an emergency fund have been provided and until a substantial amount of annuities or fixed-income securities has been accumulated. Speculation on a shoestring or with funds whose loss would cause distress has no place in a well-ordered financial program.

The present writer has placed on record his confidence that on the average and over a long period of time anyone who buys stocks of large American corporations with any degree of intelligence will make handsome profits.* Averages, however, do not help the person whose experience is unfortunate and who loses badly needed money. There is, of course, some protection against bad luck or bad judgment in adequate diversification, but the general level of common stock prices tends to fall drastically just when the owner is most likely to need funds. They have to be sold in many cases at the worst possible times. They should be purchased, therefore, only if the necessity for forced sale is not likely to arise.

Common stock prices as a whole are extremely sensitive to general economic conditions. The business cycle has been the subject of widespread discussion and argument for many years, and

* William Law, "Successful Speculation in Common Stocks," Whittlesey House, McGraw-Hill Book Company, Inc.

even the experts are not by any means unanimous in their findings. It is sufficient for our present purpose to point out that however desirable it may be to smooth out the business curve, it is highly probable that for some years to come there will be successive periods of good and bad times, and that the general level of common stock prices, irrespective of the merits of particular issues, will rise and fall. The layman can hardly hope to predict business conditions with any great accuracy, but he should be on guard against concentrating his purchases of common stocks near the top of a bull market. The culminating phase of a period of good times is usually marked by high interest rates, high employment, and very high common stock prices. It is the part of caution at such a time to liquidate common stocks or, if one is of the type who buys to hold, at least to avoid purchasing common stocks when a boiling stock market has reached the front page. Nor should such an investor buy common stocks during the downward phase of the business cycle. A period of deflation generates forces which tend to intensify bad times. Wisdom counsels waiting until definite signs of continued improvement are in evidence before buying stocks.

In selecting particular stocks, the buyer must first consider the industry or group of stocks.

Some of them involve much greater risk for the person without special knowledge than do others. Companies engaged in such business as fertilizing materials, rubber, leather, and sugar must necessarily carry immense stocks of raw materials and are greatly affected by fluctuations in the prices of those materials. As a rule, the more stable the price of the material, the more stable will be the price of the stock. Oil and copper companies are influenced to a somewhat less degree by price changes, largely because the raw-material stocks of these companies do not form as great a proportion of their assets as do those of companies engaged in the industries mentioned above, but the oil industry is very greatly affected by the discovery of important new fields. As noted in connection with preferred stocks, the estimated life of reserves is an important element to consider in the case of mining companies and oil producers, and if patents are largely responsible for earnings, the length of time they have to run must be carefully considered. Too much reliance can never be placed, in any event, on earnings from a single patented article or process, as either may be largely superseded by a new invention.

Railroad and public utility stocks labor under governmental regulation, which may prove burdensome and sometimes approaches outright

interference. Both industries are inherently monopolistic, but railroads have some competition among themselves and more with other forms of transportation, while even public utilities are sometimes placed in the position of competing with more or less subsidized governmental plants. The electric light and power and the telephone industries appear to be assured of a dependable and increasing demand for their services, but the future of railroads is somewhat doubtful. All in all, strong industrial companies in expanding industries appear at the present time to offer greater profit possibilities on the average than do railroads and utilities.

Some industries are much less affected by trade recessions than are others. Electric light and power companies, cigarette manufacturers, diversified food concerns, low-priced chain stores, and other companies producing or distributing consumers' goods are preeminent in this respect, while the so-called "heavy industries," such as iron and steel, building supply, machine tool, and railway equipment manufacturers are at the other extreme. Railroads occupy an intermediate position, but their capitalization is such that a relatively moderate reduction in business drastically reduces profits. The record of any company for the past few years should pretty fairly indicate the stability of its business. The

stocks of companies which are relatively little affected by hard times naturally do not go down as sharply as those of other companies during a depression, but, of course, when improvement sets in, they do not advance so rapidly, and it is quite possible for the shrewd speculator to take advantage of these situations. If he is convinced, for instance, that a depression is over and that business conditions are going to improve, he will buy stocks in those industries, such as the automotive and chemical, which are likely to be among the first to respond. At a later period, he will buy stocks in the construction and other heavy industries, which are generally among the last to get out of the doldrums.

To an even greater degree than in the case of bonds and preferred stocks, earnings, especially prospective ones, so far as they can be estimated, should be given first place in picking individual stocks. Such figures as book value and surplus are merely bookkeeping figures, governed by the company's own valuation of its properties, and without very detailed and expert analysis, mean precisely nothing. Such things as cash position, ratio of quick assets to current liabilities, inventory and depreciation policy may be useful, but they, too, often require knowledge of the particular industry in order to be given intelligent consideration.

A good deal has been said at one time or another about the price-earnings ratio, and the erroneous idea that there is some proper relation between these two things is quite generally held. Nothing, of course, could be further from the truth. The price of a stock is governed rather by the general opinion as to its future earning prospects than by profits already reported. A stock may sell at twenty times its current earnings and be cheap at the price, while another may be overpriced at five times its current earnings. Generally speaking, stocks of the older and larger companies sell much higher in relation to earnings than do those of small companies. If a company's business is rapidly increasing, the price of the stock will be many more times its earnings than if the contrary is the case. If its business is subject to violent fluctuations, its stock will sell lower in relation to earnings than if its business is fairly stable. The stocks of electric manufacturing, chemical, and business machinery companies usually are very high in comparison with current earnings because of the general belief that these industries will greatly expand in the future.

Unless a person is especially qualified, he should for the most part stick to the stocks of very large companies. They are less likely than the small ones to be drastically affected by

changes in management, natural disasters, sudden changes in public buying habits, and the like, and their stocks are not easily manipulated. To be sure, other things being equal, the stocks of large companies sell at higher prices than those of small ones, but for the average investor, the added security is worth the cost. In general, it is prudent for the layman to confine himself to stocks which have been listed on some important exchange long enough to ensure ample testing in a free market. Newly issued stocks are frequently supported by their sponsors, and their prices are more or less artificial.

Experience does not indicate that the dividend paid on a stock has any particular influence on its price. If a corporation retains all of its earnings, instead of paying them out to stockholders, the assets of the corporation are increased and the value of the stock is thereby enhanced. Indeed, a corporation which is not paying out a very large proportion of its earnings in dividends is in a position to increase the dividend, and the likelihood of any such action always tends to put up the price of its stock. Unless, therefore, income is an important consideration (and, if it is, fixed income securities should be bought rather than common stocks), there is no particular reason why the investor should not include in his common stock purchases low-yield

stocks or even stocks paying no dividends at all. Appreciation in value must, after all, be the principal object of common stock buying.

There is no particular reason why stock dividends and split-ups should increase the prices of stocks, except as such action may indicate confidence on the part of the directors or the probability of increased dividends. Nevertheless, when it is rumored that any such action is impending, the stock of the company invariably rises. The purchase of stock under such conditions is very likely to prove disappointing.

The intelligent purchase of common stock is difficult enough at best. The purchaser of a bond needs only to be assured that interest will be regularly paid and that the bond will be paid at maturity. Similarly, in the purchase of preferred stock, sufficient earnings to pay preferred stock dividends are all that the holder is interested in. Common stock is an entirely different matter. The buyer wants to buy the stocks of those companies whose earnings may be expected to increase, and, moreover, as pointed out earlier, the prices of common stocks are much more influenced by general business conditions than are those of fixed-income securities. Estimation of future earnings is hazardous under any conditions, and the layman should confine himself to the stocks of companies with fairly simple

capital structures. The capitalization of some of the holding companies in the public utility industry is so complex that it is difficult even for the expert to know just what their common stocks represent. Operating companies have their own bonds and preferred stock outstanding. Their common stocks are held by a holding company, which also has bonds and preferred stock. Its common stock, in turn, is held by another holding company. The stock of the top holding company is pretty far from actual operations. Even a very slight reduction in the profits of the operating companies is likely entirely to wipe out earnings of the top holding company. The purchase of such stocks should be left to those qualified to appraise them.

Diversification in common stocks is just as important as in the case of other securities, but it can be carried too far. The position of any common stock may change drastically within a short period of time, and anyone who holds such stocks should not put them away and forget them. He should keep in touch with the operations of companies in which he is interested and keep himself informed of developments likely to affect them. The ordinary person has only a limited amount of time available for such matters and can hope to keep well posted on only a relatively small number of companies. Because of

this, he should limit his holdings to a reasonable number of stocks but, within that number, should diversify not only by companies but by industries.

The subject of common stocks as a hedge against inflation was briefly discussed earlier in this book, with particular emphasis on the risks attending the indiscriminate purchase of so-called "inflation stocks," and the fact that insurance against inflation should never be attempted until the more urgent contingencies have been provided for. It was stated, however, that continuing governmental deficits and the tendency to experiment with monetary matters warranted some fear that public confidence in the credit of the Federal Government might eventually be impaired, and that the person in a position to buy common stocks might well include in his portfolio some, at least, which should profit most greatly, were that to happen.

Generally, companies with proportionately large holdings of raw materials would be among the first to benefit from an inflationary rise in prices. All of the extractive companies with large reserves of minerals or oil rank high in this respect. Gold- and silver-mining concerns would be in a very favorable position, but they might suffer from special taxation, or even from changes in the monetary systems of important countries. Moreover, stocks of these companies very

quickly reflect even the slightest prospect of inflation, and their purchase during periods when their prices have been rapidly increasing entails the risk of considerable losses. Oil, copper, and lead companies should probably be ranked next to gold and silver producers as inflation hedges, with iron and steel companies owning large ore reserves closely following them. All of the industries so far mentioned would not only be able to sell immense quantities of materials at inflated prices, but would, when inflation had run its course, still be possessed of tremendous physical assets. In this they would have an advantage over the merchandising and processing companies, such as mail-order houses, tire manufacturers, and milling concerns, which carry large inventories and would temporarily profit enormously from a rapidly rising price level, but which do not own large reserves of raw materials.

The large chemical companies carry considerable inventories of raw materials, have large fixed assets, and would be among the first to feel the effect of the temporary stimulus inflation would give to general business. As a class, they have the added advantage of a very hopeful future under normal conditions. Any companies owning large amounts of real estate would, of course, eventually profit very greatly from outright inflation.

Of course, a great many different kinds of companies besides those mentioned carry large inventories and would therefore benefit from inflation. Moreover, rapidly rising prices would temporarily stimulate general industry, and many businesses now showing losses would earn profits. For this reason, the purchase of very low-priced stocks is frequently advocated on the theory that, as they began to show profits, their prices would rise very rapidly. The danger in such purchases lies in the fact that many of the companies involved are either in receivership or pretty close to it, and that, if inflation does not occur in the near future (and there is every reason to believe it will not), these stocks may depreciate very greatly in value. One should endeavor, even while buying stocks with the possibility of inflation in mind, to confine his purchases to stocks which may be expected to appreciate in value, whether or not that possibility becomes a reality. Of course, the stocks of strong companies, selling at relatively low prices because of greatly reduced operations, may furnish a good hedge against inflation, while offering some reasonable expectation that under normal conditions their business will probably increase.

The purchase of stocks of heavily bonded companies is sometimes urged, on the ground that inflation would reduce the real burden of

their debts. This is true enough, provided the debts would mature while inflation still held sway, but here again great risk is involved in purchases made solely in the expectation that inflation will get companies out of difficulty.

Railroads and public utilities whose rates are subject to governmental control would find it difficult to increase them as fast as their costs were increasing, and would be injured rather than benefited by inflation. Of course, if they were able to keep going until inflation had run its course, their properties would still have real value, and purchases of the stocks of the stronger companies in these industries at low prices might eventually prove very advantageous. Fixed-price chain stores and other companies which, because of custom or public opinion, would have difficulty in raising prices might lose rather than gain from uncontrolled inflation.

Banks and other financial institutions would of course profit from the increased general business resulting from rising prices, but, as their assets are largely monetary, they would not profit from inflation so much as would companies owning important physical assets.

The purchaser of common stocks should particularly remember that the possibility of inflation is at most only one factor to be taken into consideration. The point bears emphasis because the

possibility of large profits is likely to warp the judgment of even an ordinarily sensible person. Ownership in a gold mine or an oil well is apt to prove very alluring when inflation prices appear in prospect. It is especially necessary, therefore, when selecting stocks with inflationary possibilities, to keep the realities in mind, and to consider not only what particular stocks might do under the spur of mounting prices, but what may be expected of them under the normal monetary conditions which are more likely than not to continue. Nor should the possibility of inflation influence one to disregard the absolute necessity of diversification.

The important thing in buying common stocks is that they be purchased only after some sort of intelligent appraisal of their possibilities. One may justifiably buy a stock because he believes that its earnings warrant higher prices, or because he believes that the industry has great future possibilities, or because he has such confidence in the management of the corporation as to believe that it will make progress. But a very considerable amount of stock buying is done for no other reason than that rumors are being circulated or that prices are going up. This sort of stock buying pretty rapidly degenerates into mere gambling with numbers, and this kind of gambling is done against tremendous odds. There

is a very real danger that the investor may start out buying stocks on an intelligent basis and soon find himself switching from one stock to another in the effort to pick fast movers. If the owner of stocks finds that his turnover is increasing and that his stocks are being held for shorter and shorter periods, he can be pretty sure that he is on the road to large losses.

Chapter Twelve

MORTGAGE LOANS AND PARTICIPATIONS

MORTGAGE loans are the oldest investments in the modern sense of which we have any record. They go back to very ancient times indeed. Not only because of their long and for the most part honorable record, but because they are based on land and buildings, two of the most fundamental human necessities, loans secured by real estate occupy a very high rank in the investment field. They constitute a large proportion of the portfolios of life insurance companies and savings banks, and of course, a preponderant part of those of building and loan associations and land and mortgage banks. In one form or another, they occupy an important place in the investments of individuals, and it is our first purpose to inquire into the question as to whether they are entirely suitable for that purpose.

Before the era of big apartment houses and office buildings, mortgage loans were usually made by the lenders directly to the borrowers, the negotiations being carried on in some cases

through brokers or agents. Mortgages were for the most part of small amount. Very often wealthy individuals held mortgages on residences in their localities, and we all remember the villainous skinflint of the old melodrama, forever threatening the honest heroine's mother with eviction from her old homestead unless the heroine should yield to his base desires. Very possibly the owner of mortgages does not always covet the widow's daughter, but there are, perhaps, sound reasons for the unpopularity of the individual mortgage lender.

In the last analysis, the safety of a mortgage loan rests on the value of the real estate pledged. To be sure, a loan of this kind is evidenced by the borrower's note as well as the mortgage, and if at foreclosure sale not enough is realized to satisfy the loan and costs incurred, the borrower is liable for the balance, but in actual fact, few deficiency judgments obtained under such circumstances are ever collected. There is an increasing tendency on the part of large institutional lenders to consider the financial responsibility of borrowers as well as the value of the pledged property, but it is safe to say that the governing factor in real estate loans will always be the value of the mortgaged property. Careful appraisal of real estate, then, is the first essential for intelligent lending on mortgage.

Real estate appraisal is usually a job for an expert. It is largely based on the capitalization of earnings. At first sight, that would seem to be a simple problem in the case of fully rented property, but such is far from the case. The lease or leases may have been entered into when general conditions were different from those existing at the time of appraisal, and if so there is no assurance they will be renewed. A mortgage loan usually runs for a period of years, and all sorts of changes in the property itself or in the neighborhood may take place before it matures. What today is a high class residential section may within a short time become a tenement district. Public improvements of benefit to the locality may greatly damage individual properties. The structure itself may be of flimsy construction and subject to rapid depreciation. Leases may have been made to irresponsible persons, and may have been coupled with concessions amounting in substance to reductions in rent. A particular property may be greatly injured by construction in adjoining or neighboring plots. Such are some of the difficulties in properly appraising fully rented buildings.

Capitalizing the probable earnings of new buildings offers still greater difficulties, for it involves estimating the rent which can be obtained. If vacant land is to be pledged, appraisal neces-

sitates estimating the cost of improving it to the best advantage and the probable income which can then be derived.

Thus far, we have considered only the income side of the equation, but there are costs attendant on real estate ownership. Taxes are important and as all the world knows are subject to change without notice. A drastic increase in taxes may seriously reduce the value of the real estate affected. Buildings must be kept in repair, and rising prices will increase the cost of this. If a building is not well constructed, maintenance charges may consume a much larger part of the income than would normally be expected. Large apartment and office buildings are costly to operate, and a moderate reduction in rentals may very greatly reduce the income available for mortgage interest.

Many attempts have been made to formulate systems of real estate appraisal, and some of them are extensively used and do simplify the problem to some degree. At best, however, these systems are valuable only as tools for the qualified appraiser and cannot take the place of experience, good judgment, and a careful consideration of probable future developments. Anyone can, perhaps, make general inquiry as to rentals in a particular neighborhood, and the prices at which real estate parcels have changed

hands, but the approximate ideas of real estate values obtained by any such process are hardly a sufficient basis for lending money.

Appraisal of the pledged property is not the only difficulty involved in mortgage lending. Many bothersome details are involved. The lender must, before closing the loan, make sure that title to the property has been properly searched and guaranteed, that adequate insurance is carried, that taxes are paid up, and that the note and the mortgage are properly drawn and sufficiently protect his interests. After the transaction has been closed, he must see that the insurance is kept up, that the mortgage is recorded by the proper public authority and by the insurance company, that taxes are promptly paid, and that the building is not allowed to fall into disrepair. The average individual investor must, of course, employ a lawyer when the loan is negotiated, and the borrower is usually required to pay the fee. Institutional lenders have facilities for obtaining the necessary legal and other services at low cost, but the individual may be in no such position. Moreover, the private investor will want compensation for the trouble to which he is put and the risk he must necessarily undergo, and will demand a fairly high rate of interest. When the mortgage matures, he will perhaps be in no position to renew it or he

may have decided that mortgage lending is not to his liking, or he may possibly see an opportunity of obtaining the pledged property at a bargain price. Whatever the reason, the borrower, who ordinarily expects to renew, will not be kindly disposed toward the hard-hearted lender who insists on payment.

All these considerations prompt the borrower on mortgage to place his loan, if possible, with an institutional lender, and the mortgages offered to individuals are usually not the choicest there are. It is not surprising, therefore, that direct mortgage transactions between borrowers and private investors have rather fallen into disfavor and that mortgage lending by individuals has tended to take the form of investments in mortgage loans or participations therein, which are sold and serviced by corporations specializing in that field of finance.

There is, of course, another reason for the recent rapid development of this form of real estate lending. When mortgages were very largely liens on homes, the amounts were moderate and within the means of individual lenders. That is not the case with loans on large buildings. They must be subdivided if they are to be made available to small investors. This is accomplished through the instrumentality of

mortgage bonds and certificates and collateral trust bonds and certificates. The difference between the first two is technical rather than actual. Bonds are signed by the borrower and are secured by a mortgage. Certificates are simply evidences of participation in an actual bond and mortgage. In one case, the borrower signs each bond, while, in the other case, he simply signs one obligation. The result is the same, except that in some states real estate bonds are not legal for certain kinds of investments, while certificates are. Collateral trust bonds and certificates differ from these securities only in that they constitute participations in groups of mortgages, instead of in single mortgages. They permit greater diversification than the former but involve complications in case of default.

Mortgage bonds or certificates may or may not be guaranteed. In some cases, they are guaranteed by the mortgage company or an affiliate and, in other cases, by title companies or surety companies. If the bonds or certificates are not guaranteed, their strength rests entirely on the value of the mortgaged property, while, if they are guaranteed, there is the additional factor of the strength of the guaranty. This depends on the relation between the guaranteeing company's resources and the total amount

of bonds it has guaranteed or may guarantee and, even more than that, on the care and judgment it has exercised.

The mortgage company, of course, endeavors to see that the lender's interests are properly safeguarded by the terms of the mortgage, that adequate insurance is maintained, that taxes are paid, and that the property is kept in repair. It collects interest and principal from the borrower and pays the certificate holders. If it has guaranteed the certificates, it pays on the due dates, if not in receivership, whether or not it has collected from the borrower. In short, the house selling mortgage participations not only appraises the pledged property, but takes care of all the burdensome details.

Some mortgage houses sell individual mortgages to private investors. They do not ordinarily guarantee but, inferentially at least, recommend them as safe securities. They perform all the services outlined above in connection with certificates. The person buying mortgages in this way has the opportunity of at least forming his own opinion as to the value of the pledged real estate and in case of default can take possession. Such loans, however, are more likely to be adversely affected by local developments of one sort and another than are loans on large buildings.

The recent history of mortgage participation securities is too well known to require extended comment. They became extremely popular during the postwar boom, and tremendous amounts were sold to people who had no thought but that they were making safe and conservative investments. Then came the depression, and as it became intensified, many issues defaulted and many of the guarantors went into receivership. Subsequent investigations disclosed that bad judgment, carelessness, undue optimism, and outright fraud had characterized the operations of many mortgage companies. In many states legislation has been passed designed to prevent future abuses of this kind, but it is at best very questionable whether they can accomplish this purpose, and there is some ground for believing that, as a class, real estate securities possess certain inherent features which render them less suitable for the uninformed investor than some other forms of investment.

First and foremost, the buyer of mortgage certificates (the term will be used for the sake of brevity to include all types of mortgage participations) must to all intents and purposes rely on the sound judgment and good faith of the mortgage concerns with which he deals. These companies depend on the marketing of certificates for their profits and must compete not only with

each other, but with institutional lenders in the search for business. Other things being equal, a borrower usually prefers to place a mortgage with an insurance company or savings bank rather than with a mortgage underwriter. The result is that the latter are tempted to arrange loans for larger percentages of the values of pledged properties than is altogether conservative. Furthermore, in an endeavor to increase profits, they sometimes guarantee mortgages to amounts out of all proportion to their capital funds. Laws may be passed restricting the percentage of value of mortgaged properties for which certificates may be issued, but it is difficult to see how overappraisals can be prevented. An investor may, to be sure, have unlimited confidence in the management of a particular house, but the wisdom of trusting one's funds to the judgment of a few individuals is open to question, and there is no assurance that management and policies will not change.

The second objection to real estate mortgage certificates, from the private investor's standpoint, lies in the drastic effect that economic depressions have on the net income of residential and office buildings, combined with the fact that, when rentals prove insufficient to cover taxes and mortgage-loan payments, the owner of realty is seldom in a position to keep on paying these

charges very long out of his own resources. A strong corporation with bonds outstanding can often continue paying its obligations for a long period in the face of continued deficits, but that is not usually true of real estate owners. If earnings decline sharply, default usually occurs. A life insurance company or a savings bank can take possession of the pledged property in case of default, spend money on it if necessary, manage it until conditions improve, and eventually sell it, very possibly at a profit; but holders of certificates are in no position to take concerted and effective action to protect their interests. They must depend on committees, unfortunately not always so constituted as to work solely for the benefit of those they are supposed to represent. Raising money to put properties in good condition is often difficult, and management under committee direction is not always capable or economical.

Mortgage certificates do not enjoy active markets. Aside from the resultant lack of salability, which may not of itself be of great importance to investors who are primarily interested in income, this is a great disadvantage to the uninformed buyer, in that it deprives him of combined, disinterested opinion as to the merit of particular issues. We have seen that a person can buy an active bond with some assurance that

he is paying a fair price for what he gets, and that yield is in some sort of proportion to risk. No such assurance is possible in purchasing mortgage certificates.

When hard times come, the sympathies of governments flow out to the unfortunate people who have bought homes with other people's money, to the exclusion of any consideration for the poor devils whose savings have been used. Some of the legislation actually enacted for the relief of mortgage debtors, to say nothing of measures that have been proposed and widely supported, is such as to discourage the careful investor from placing much faith in mortgage covenants. Common sense may come into its own again, and the courts will probably prevent outright spoliation of mortgage holders, but the danger of mortgage contracts being changed by law is an element which should not be ignored.

Finally, these certificates offer no such possibility of adequate diversification as do bonds, nor do they possess the important quality of availability as collateral for loans. All in all, one is forced to the conclusion that, on the average, mortgage certificates are not as desirable a form of investment for the individual as are corporate bonds giving a like return.

Within recent years, a new form of real estate security has been developed. Preferred stock is

sold by the builder for an amount sufficient to pay the excess of the cost of the property over the amount borrowed on mortgage. Common stock is also issued, half of it going to the buyers of the preferred stock and half to the builder. It is usually provided that the preferred must be retired before dividends are paid on the common. It will be noted that between them the mortgagees and purchasers of preferred stock take all the risks, the builder participating only in the profits. The more structures the builder can erect with other people's money, the larger his eventual profits may be. Such a system does not tend to overconservatism, and in any event, there is no cushion to protect the preferred stockholder against depreciation in the value of the property. For the prudent investor, the possibility of eventual profits can hardly outweigh the risk involved in buying this type of security.

Another form of investment based on real estate mortgages consists of deposits in building and loan associations. Their assets consist largely of first or second mortgages on the homes of members, the terms of the loans requiring regular amortization. In some cases, deposits are accepted for members only in the form of regular periodic payments, but some associations sell certificates in unlimited amounts to non-members. Provisions as to the sale of certificates before

maturity and as to borrowing on them are too varied to permit of enumeration. Interest is usually declared from time to time, on the basis of earnings, but averages very much higher than the dividends declared by savings banks. An instrumentality of the Federal Government has recently been formed which guarantees deposits in approved associations up to $5,000, and unless the law is declared unconstitutional, certificates so guaranteed would appear to constitute pretty safe investments, at least so far as principal is concerned. In the case of non-insured associations, bad judgment, fraud, changes in particular localities, and economic depressions might cause heavy losses to non-borrowing depositors and certificate holders.

While our discussion has thus far been confined to loans secured by mortgages on residences and office buildings, nearly everything said applies with equal or greater force to farm mortgages. Appraising farms requires just as much expert knowledge and good judgment as does the appraisal of urban real estate. The choicest farm mortgages are eagerly sought for by institutional investors and quasi-governmental agencies. The chances are that such loans offered by dealers to the general public are not of the safest character. The private investor is seldom able to form any intelligent idea of the soundness of a farm

mortgage loan and should leave investments of this character to those who can.

To avoid any possibility of misunderstanding, the writer should emphasize his opinion that conservative mortgage loans, founded as they are on something of basic and permanent value, are among the most desirable forms of investment for institutions and even for individuals equipped to appraise them wisely and to manage them to good advantage, should that become necessary. Few private investors fulfill these conditions.

Chapter Thirteen

HOME OWNERSHIP AND OTHER INVESTMENTS IN REAL ESTATE

So many eminent persons have preached the doctrine of home ownership with almost religious fervor that it appears to be flying in the face of all constituted authority to intimate that renting is often the wiser policy. Nevertheless, it is pretty safe to say that there are quite as many people who wholeheartedly regret the purchase of homes as there are of those whose experience with this type of investment has proved satisfactory.

We are not, of course, concerned with the question of whether those who own homes are the backbone of the nation, nor with the social and economic aspects of the subject, but must confine ourselves to inquiring into the circumstances under which home ownership may be expected to prove a good investment.

Such sales arguments as "Own your own home and save rent" (real estate promoters, not the author, are responsible for the tautology) and

"By our easy payment plan you can own your home for what you now pay in rent" have a superficial appeal but will not bear analysis. The rental a landlord can obtain for his property is fixed generally by the supply of similar quarters and the demand for them. The value of a piece of real estate is determined by what it can be rented for, not vice versa. In the long run, however, construction falls off when rentals do not yield an adequate return to real estate owners, and the supply of usable buildings decreases until higher rentals can be obtained. Just what constitutes an adequate return is not subject to accurate determination, but it is obvious that the rent of a house includes such items as taxes, insurance, maintenance, depreciation, and obsolescence, and in most cases mortgage interest, in addition to interest on the owner's investment and something to compensate him for the risks entailed in ownership. The many ways in which real estate values can be adversely affected beyond any ordinary obsolescence were alluded to in connection with mortgage loans. The landlord, of course, may also suffer from vacancies and undergoes some risk of having to pay damages for injuries incurred, or claimed to have been incurred, on his premises.

When any one buys a house, all of these items

must be paid, except the landlord's profit or compensation for risk. The owner assumes that risk himself, except to the extent that the chance of vacancy is eliminated. This gives us the clue to one of the requisites for successful home ownership—the assurance that the home can be occupied for a long time with satisfaction to the owner. In considering this important subject, the prospective buyer must bear in mind not only the possibility of such adverse developments as those referred to in connection with mortgages, but many factors of a personal character. Can he be reasonably certain that the house will be suitable for himself and his family, not only under existing circumstances, but after such changes as may occur? There may be additions to the family or an increased income. Will the house still be satisfactory if any of these things occur? Will neighbors be congenial, and will the locality be convenient for all members of the household, as far as can be foreseen? If there are children, are educational facilities adequate? Is the owner reasonably certain that he will not have to move to another city? Most important of all, is the home within his means, and if there is a mortgage, can it be renewed without difficulty? Is the buyer in a position to pay a goodly proportion of the purchase price without financially crippling himself? It is im-

portant that repair and maintenance costs be generously estimated, and that the possibility of increased taxes or assessments be borne in mind.

It cannot be too strongly emphasized that more home buyers have come to grief through taking on more than they could really afford than through any other cause. High pressure salesmanship, harping on the plausible arguments already referred to, has been responsible for the purchase of thousands of homes under conditions which could only result in disaster. People have raised the required down payments by every possible means, have taken the rosiest possible view of the future in obligating themselves to make future installment payments, with the inevitable result of losing their homes when their too optimistic budgets failed to prove adequate. Unless one can pay for a substantial equity without borrowing and while still maintaining a sufficient emergency fund, he would do better to keep on paying rent.

It is frequently urged by real estate salesmen that increase in land values more than compensates for building depreciation, with the result that real estate as a whole tends to appreciate in value, and many a person has bought a home on the theory that, if continued occupancy should prove impossible or undesirable, the

property could be sold without loss. This reasoning does not usually prove to be sound. While it is undoubtedly true that over a long period of time land does enhance in value in growing communities, the exceptions are too numerous to prove the rule, and one has no assurance that he will not want to sell just when conditions are bad. Indeed, it is more than probable that such will be the case. Moreover, any particular locality may be more or less permanently on the downgrade, and even if real estate prices in the neighborhood are generally rising, the market is rarely active enough to ensure that an owner can sell a particular property to advantage. He may have to wait a long time before a buyer is found. Meanwhile, taxes and insurance must be paid and the structure kept in good repair.

The purchase of a home should be made with greater care, probably, than is essential for any other form of investment. Before committing himself, a prospective buyer should live in the community for some time and study its character and try to estimate the possibility of future developments. He should, if possible, rent and live in the house he proposes to buy. He must carefully examine its construction, or have someone better qualified than he is do so. Finally, he should endeavor to buy when rentals and real

estate values are depressed. Strangely enough, the temptation to buy a house is greatest when rents are high and increasing, but rent is temporary, while an investment is permanent. It is far better to continue paying a stiff rent for a few years than to buy at a price which reflects that rent.

It goes without saying that one buying a home must make sure that he acquires good title, that taxes have been paid, that there are no claims or judgments against the property, and that his ownership is properly recorded by the appropriate public officials and the mortgagee, if any. If a mortgage is held by an individual investor or a commercial bank, he would do well to have it transferred if possible to some institution for which mortgages constitute desirable investments and thus avoid the possibility that renewal will be refused at a period when mortgages are difficult to place.

When a home is purchased under suitable conditions, it constitutes one of the best hedges against inflation, without the risk attendant on most forms of protection against that contingency. It is frequently urged that the smaller the owner's equity, the more he will profit if inflation occurs, as the mortgage indebtedness will become a lesser burden in terms of real value as the general price level rises. Perhaps, but the

greater profit possibilities are offset by the risk that, if inflation does not come, the owner may be unable to meet his mortgage obligations and will lose his home.

While home ownership for the most part implies the ownership of a house, cooperative apartments have become sufficiently common to warrant discussion. The plans differ greatly in detail, but generally the builder negotiates a first-mortgage loan for from 40 to 60 per cent of the cost of land and structure, and forms a corporation, capitalized at an amount which includes the balance of the cost plus his own profit. This stock is divided among the apartments on the basis of rental value. The buyer of an apartment subscribes for the stock allotted to the apartment selected and signs a long lease, often of ninety-nine years, under which he agrees to pay his share of the total rental fixed by the corporation each year to cover estimated expenses. The general practice is for the directors, elected by the owners from among their own number, to estimate expenses generously in fixing rentals, in order that the corporation may accumulate a surplus. The bylaws usually provide, in effect, that the corporation must approve any sales of stock or rentals. In practice, this means that any owner can veto the proposed sale of stock by another owner, and that the builder

can sell stock only to purchasers satisfactory to those who have already bought apartments.

The corporation is responsible for the maintenance of those parts of the premises used jointly, but each owner of an apartment must pay for its upkeep. Very frequently a buyer does not pay for his stock in full, but makes a down payment and agrees to pay the balance in installments, the builder holding the stock until it has been fully paid for. The latter may refinance such operations, and it is common for operators to borrow from financial institutions on unsold stock.

The advocates of cooperative apartment ownership advance much the same arguments as those used generally in behalf of home buying, but they also contend that the person buying an apartment assures himself of congenial neighbors, and they maintain, without much justification, that operation under cooperative ownership is more economical than under landlord management. From a financial standpoint, an investment of this type is subject to all the risks entailed in buying a house, with some more thrown in for good measure. As long as a man can pay debt service charges, taxes, and insurance, he can keep his house, and if he wants to sell it, he need only find a buyer. Not so in the case of an apartment. His fortunes are bound

up with those of the co-owners. If the builder is not successful in selling much of the stock, he is likely to fail, and those who have already purchased apartments must either carry the entire burden or lose their equities when the mortgagee forecloses. If an owner cannot keep up his end or for any other reason wishes to sell his stock, he must not only find a buyer but obtain the approval of the committee which passes on such matters. Of course, if the stock has not been fully paid for, the builder may buy it for the balance due, or the corporation may buy stock from its surplus. In actual practice, however, an owner is likely to have to sell when general conditions are bad, and, under such circumstances, may not be able to sell at any price. In a case of this kind, the almost perpetual obligation to pay an undetermined rental may prove embarrassing in the extreme, and it has not been unusual in recent years to see an advertisement offering an expensive apartment for one dollar.

During a depression, many owners are unable to pay their rent and either move out or are evicted. They are usually in no position to pay for decorations and cannot rent their apartments without doing so. The remaining owners must pay increased shares of the expenses, and they, too, may be unable or unwilling to put the vacant

apartments in condition for rental. Under such circumstances, the jointly used premises are not adequately maintained, service deteriorates, and sooner or later the mortgagee forecloses, relieving the owners of their equities and their troubles. This is not by any means an exaggerated portrayal, and it is safe to say that most of the cooperative projects undertaken during the culminating phase of the new economic era have brought nothing but all kinds of assorted grief to both the builders and the apartment buyers.

During a period of prosperity, conditions are far different, but even then an owner who finds his apartment unsuited to his needs or for any other reason wishes to vacate and to sell his stock, is likely to find it difficult to do so. The other owners are not at such a time particularly concerned about their co-owner's troubles, and may prove hypercritical in considering prospective buyers. Indeed, there is some reason, at least, to question the inherent soundness of any plan which involves putting a large amount of money into something which can be sold only with the co-owners' consent.

In any event, no one should consider buying a cooperative unless he is certain that it will continue to prove a satisfactory home, that arrangements have been concluded for the sale of all apartments to owners who may be expected to

remain financially responsible, or that the builder's ability to carry through is beyond question, and that the price asked is a fair one. A builder is entitled to a substantial profit in view of the risks he takes, but in many cases, the prices asked are inflated beyond all reason. If a buyer can learn the mortgage appraisal, that may give him a clue as to whether or not too large a profit is involved and also as to whether financing has been conservative. As in the case of purchasing a house it is extremely important that a person should not buy an apartment unless he can well afford to acquire a substantial equity. The possibility that the rental may be greater than the builder estimates should not be lost sight of, and a generous estimate of repair and maintenance expenses should be included in one's calculations.

Aside from home ownership, real estate may of course be purchased as an investment, and many great fortunes have been accumulated in this way. However, enough has been said of the expert knowledge required for intelligent real estate appraisal and the many ways in which values of realty may be affected, to indicate the risk attending investments of this kind. It should be remembered, too, that while land values tend to increase in growing communities, there is no assurance that they will do so in well-settled

localities, and that immense sums of money have been lost as the result of the collapse of real estate booms. For the person without special knowledge, real estate investments, aside from home ownership, do not fit in with a well-ordered plan for financial security.

Chapter Fourteen

EFFECT OF TAXATION ON A SECURITY PLAN

THE thrifty are the natural prey of those who frame the tax laws. Everyone is taxed from the cradle to the grave, but the man who saves is taxed after he reaches it. The doctrine of taxation according to means has much in its favor, but it sometimes presses hard on those who are trying to make provision for the future. Taxation increases their insurance premiums, reduces the income from their savings, and cuts into their gifts and bequests. Discouraging as it may sometimes seem, the man who looks to the future must nevertheless continue to make provision for himself and his dependents, even though government may be a large if incidental beneficiary. All he can do is to conduct his affairs in such a way that his taxes will be as small as the law allows. Not much can be said for outright tax evasion from the standpoint of either ethics or policy, but there are many ways in which one may with perfect propriety and legality keep

taxes to a minimum. It is, of course, hard to draw the line between proper and questionable tax avoidance, but it is safe to say that one could scarcely be criticized for taking any straightforward action with a view to taking advantage of definite statutory provisions, whereas a tortuous involved procedure designed solely to escape taxation might not be well received by the authorities.

The point is important, because questions as to whether particular taxes are assessable are finally decided by administrative officials and courts of law, and their attitude may be greatly influenced by their opinion of the good faith of those concerned. As taxes become greater, efforts to evade them increase. One person quite justifiably makes a certain provision and incidentally saves taxes. The word gets around, and what with attorneys, trust company employees, and insurance agents all setting up as tax experts in an effort to sell their wares, soon thousands of people are using the same means purely and simply to dodge taxes. A law is passed or a regulation issued which plugs the hole and plugs it just as effectively for the innocent as for the guilty. Very frequently the new law or regulation makes ineffective some arrangements that have already been made. Quite aside, then, from the question of ethics, one should be wary about

attempting to escape taxation. Such efforts may prove not only abortive, but embarrassing.

Aside from the fact that taxes are levied by the Federal Government, forty-eight state governments, and countless political subdivisions, there would be no point in attempting to give any actual tax schedules, because they may be obsolete when this book is published. The only protection for the thrifty is to keep abreast of tax laws as they are enacted, study their effect, and plan accordingly. All that can be attempted here is to discuss briefly the provisions of existing tax laws which may have an important bearing on estate management and disposition.

The only proceeds of life insurance policies taxable as income by the Federal Government are the amounts by which maturing endowment policies exceed the premiums paid. Amounts paid as death benefits, cash surrenders, loans, or dividends are not taxable. Premiums are not deductible from income, but loan interest paid in cash or by addition to principal is deductible. The amount received in any year under an annuity contract up to 3 per cent of the consideration paid for the contract is considered income subject to taxation, and everything received after the non-taxed amounts received equal the consideration paid is subject to income taxes. The amounts paid under an installment

contract in excess of the consideration paid for it are also taxable. The general practice is for states levying income taxes to follow the lead of the Federal Government.

While mentioned in the chapter on bonds, the effect of tax-exemption features on bond yields should be emphasized. Interest on United States Government bonds to a principal amount of $5,000 is exempt from all Federal and state income taxes, and on bonds over that total from the Federal normal income tax and all state income taxes. Interest on a bond of a state or a political subdivision is exempt from Federal income taxes, from any income taxes levied by the state in which the bond was issued, and usually, but not necessarily, from taxes levied by other states. Interest on corporation bonds is generally subject to income taxes, but in the case of some issues, the Federal income tax up to a stated maximum is paid by the corporation. The yield less tax of any bond for a particular owner depends, then, on its actual yield, its tax-exempt or tax-paid features, if any, the state in which the individual pays taxes, and the amount of taxable income. For a wealthy person resident in New York State, for instance, a corporation bond yielding 6 per cent, a New York State bond yielding 3 per cent, and a United States bond yielding 2.90 per cent might

actually give him yields after income taxes of 3, 3, and 1½ per cent. To a person of moderate income, the comparative figures for the same bonds might be 5, 2.9, and 2.8 per cent. Roughly, United States bonds are most desirable for those subject to normal income taxes, and other public bonds are particularly attractive to those residents of the states of issue or of other states which do not tax public obligations, whose incomes are in the higher tax brackets. It is perhaps needless to stress the importance of keeping tax exemption and payment at the source in mind when computing income tax returns, if any bond interest has been received.

Bond income may be reported on an accrual and amortization basis, but this involves very complex accounting, and it is only in rare instances that the procedure would be advantageous. Only a very wealthy person would be justified in considering it. Usually the sensible course is to report as income interest actually received and to report profits or losses when bonds are sold or mature.

The Federal income tax treatment of profits and losses from the sale or exchange of securities is somewhat complicated but may have an important bearing on one's security transactions. If a security is held for a year or less, the entire profit or loss is included in the income computa-

tion; if it is held over a year, but not over two, only 80 per cent is included; if over two, but not over five, 60 per cent; if over five, but not over ten, 40 per cent; and, if over ten years, only 30 per cent. If one's income is in the higher brackets, and the sale of a security is being considered near the date at which the percentage would change, it might pay to postpone the sale past that date in the case of a profit, or to hasten it in the case of a loss. As credit for losses is limited to profits plus $2,000 an individual subject to high income taxes might find it advantageous to take losses if possible in taxable years in which profits were also taken. Generally, of course, this provision of the income tax law encourages holding for at least ten years securities which show profits subject to tax, and the fairly prompt disposal of securities on which losses have been incurred, but in each case the circumstances determine the actual effect of any transaction. Other considerations than taxes should usually govern the sale of securities, and only persons in the upper tax brackets need pay close attention to this feature of the income tax law.

The same thing is true of those provisions permitting full deduction for bonds or preferred stock determined to be worthless. A wealthy person might actually gain by holding bonds of preferred stocks until they could be reported as

worthless, instead of selling them for small amounts and being permitted only partial credit on the losses so sustained. These vagaries of the law are not of wide enough interest to warrant further comment.

The present Federal Income Tax law does not prohibit or penalize the sale and immediate repurchase of securities showing profits. Consequently one having large losses to report may advantageously sell securities on which there are profits and buy them back. This course enables him to offset the profits with the losses, whereas otherwise he could take credit for losses only up to $2,000 and would ultimately have to pay taxes on at least part of the profits.

Estate and inheritance taxes, often referred to as death duties, and gift taxes have a very important bearing on the disposition of substantial estates. An estate tax, as indicated by its name, is levied against the estate, whereas inheritance taxes are paid by the heirs. The Federal Government levies estate taxes; most states levy inheritance taxes and many of them estate taxes, too. The difference is not very practical as, in the last analysis, the beneficiaries must pay both of them. The Federal Estate Tax law provides for valuation of a gross estate either as of the date of the decedent's death or, subject to certain conditions, as of the date one year after the

decedent's death, as the executor or administrator may elect. Life insurance payable to the decedent's estate, all other life insurance in excess of $40,000, and the value of trusteed property in any way subject to decedent's control at the time of his death are included. The law provides that the following, subject in some cases to certain restrictions, shall be deducted from the gross estate, to arrive at the value of the net estate:

1. Funeral expenses.
2. Administration expenses.
3. Claims against the estate.
4. Unpaid mortgages on property included in the estate.
5. Amounts reasonably required and actually expended during the settlement of the estate for the support of those dependent on the decedent.
6. The value of any property in the gross estate situated in the United States, acquired by inheritance from a person who died within five years, or acquired by gift within five years, upon which Federal estate or gift taxes were then paid, and also property acquired in exchange for property so acquired.
7. The value of bequests to the United States, any state, or a political subdivision thereof, and to non-profit religious, charitable, scientific, literary, educational, and war veteran organizations.
8. An exemption of $40,000.

The tax on the remaining net estate begins at 1 per cent and rises by graduated steps to 70

per cent on very large estates. A credit is allowed for any estate or inheritance taxes actually paid to states up to 80 per cent of the Federal tax computed on the basis of the 1926 Act, which fixed much lower rates than the Act of 1935. Most of the state laws provide exemptions of different amounts and kinds, some of them varying according to the degrees of relationship of the heirs.

Except for the specific exemptions outlined, insurance is generally subject to estate and inheritance taxes, unless it is payable to personal beneficiaries, designated irrevocably, and unless every vestige of control is relinquished by the insured* and premiums are paid by the beneficiary.

Graduated Federal taxes, less onerous than estate taxes, are levied on gifts, and an irrevocable beneficiary designation is considered a taxable gift of the present value of the policy computed according to a somewhat involved formula. If such designation is made when a policy is taken out, the premium then paid is a

* Recent decisions appear to indicate, however, that the insured may, without rendering insurance subject to estate taxes, specify that, if the beneficiary dies before he does, the insurance will revert to his estate. If under these circumstances the beneficiary does predecease the insured, the insurance becomes taxable, unless another irrevocable beneficiary is named.

gift, and, of course, money given to the beneficiary by the insured to pay premiums constitutes a gift.

The present Federal Gift Tax law exempts gifts made by one person during any year not exceeding $5,000 in value, and not of future interest, and allows an additional total exemption of $40,000, which may be used in part or in whole at any time. Thus, if a person's total gifts in a year aggregate $8,000, he may use up $3,000 of his total exemption in addition to the annual exemption. Gifts to the United States, any state, or political subdivision thereof, and to non-profit charitable, religious, educational, scientific, and war veteran organizations in the United States are generally exempt from gift taxes.

Estates devised by will are, of course, subject to estate and inheritance taxes, except for such amounts as are exempted. If a person with a large estate leaves it to his wife, and she, after his death, wills it to other persons and survives him by five years, these taxes must be paid at both changes of ownership, whereas if the owner leaves the estate in trust, the income to be payable to the wife as long as she lives, the principal thereupon passing to other persons, the taxes are payable only once. Or if the owner establishes an irrevocable living trust along the same lines, only a gift tax is payable, unless it is subsequently

decided that the trust was established in contemplation of death. A person with a substantial estate may be able to reduce income taxes by giving part of the estate, either outright or by irrevocable trust, to members of his family.

A person who has large resources and considerable life insurance may irrevocably designate beneficiaries and give them, or irrevocably trustee for their benefit, securities the income of which will pay the insurance premiums. All estate and inheritance taxes on the insurance and conveyed property will thus be avoided, and income taxes very probably reduced, only gift taxes being incurred. But, in situations like this, one must be sure of his ground, and a qualified attorney's advice is essential.

Ordinarily, death duties are paid by the executor or the administrator on the entire estate, including such insurance as may be taxable. If the insurance has been paid directly to beneficiaries, the executor or the administrator may recover from them their proportionate shares, unless he can deduct them from bequests under the will. The tax payable by each beneficiary depends on his or her share of the estate, exemptions, in some cases the degree of relationship, and, of course, on anything the will itself may contain bearing on payment of taxes. When life incomes and remainders are involved, com-

plicated situations arise, present values having to be calculated on the basis of life expectancies and discount rates.

The importance of providing sufficient liquid assets to take care of death duties, and the suitability of life insurance for this purpose have been sufficiently indicated in earlier chapters.

The whole subject of taxation is an exceedingly complex and difficult one. Many of the laws are far from simple, and their application to different situations is being constantly affected by official regulations and judicial interpretations. New moot questions constantly arise. Anyone with a substantial estate must familiarize himself with the Federal laws and those of the state or states by which his estate may be taxed, and when such laws are amended, review the arrangements he has made in the light of the changes. If large amounts are involved, he should consult with his attorney and his trustee, and, so far as insurance is concerned, with representatives of his insurance companies.

Chapter Fifteen

THE SOCIAL SECURITY ACT

THE somewhat apathetic attitude of the public toward the recently enacted Social Security Act is perhaps not surprising in view of the fact that the direct effects of the act will not be felt for some time to come. Taking a longer view, President Roosevelt cannot be accused of exaggeration in calling it the most important legislation passed during his administration. Indeed, if it remains on the statute books, it may well prove to be the most far-reaching single law ever enacted by an American Congress. When the taxing provisions of the act reach their maximum effectiveness, the great majority of American employees, many of whom have never felt direct taxation at all, will be taxed 3 per cent of their salaries not in excess of $3,000, most large and medium-sized employers will be taxed to the extent of nearly 6 per cent of their pay rolls, and the reserve funds created by the legislation are expected eventually to aggregate some fifty billions of dollars. The act will have

tremendous social and economic consequences if it remains in force, and anyone who gives sufficient thought to the future to formulate an individual financial program should know its principal features and consider the extent, if any, to which it will supplement his own plan for security.

To be sure, the Social Security Act is designed primarily to protect those who cannot or will not provide for themselves, but the idea that social security is in conflict with individually provided security has no basis in fact. As we shall see, the act is in large part directed toward forcing individuals to make provision for their own future. Primarily, at least, it is neither a "Soak-the-Rich" nor a redistribution-of-income scheme. Insofar as it makes safe provision for an individual's future needs, he is relieved of doing so himself, and it would be idle to deny that it is possible for anyone with an earnest desire to carry out a plan for individual security to be reduced, through no fault of his own, to circumstances in which government protection might assume primary importance. While the merits and demerits of the act do not really fall within the subject of the book, it may be remarked in passing that the attitude of our most rugged individualists toward the plight of the less fortunate members of society is scarcely cal-

culated to help preserve the existing economic order, and that a sympathetic view of efforts to make less economically hazardous the lives of the American people is not at all inconsistent with an ambition to get ahead in the world and to make better provision for oneself and one's family than government can ever do.

This is not to say that an attitude of unthinking acceptance is any more to be advocated than one of blind obstruction. It is more than possible that the present scheme will prove to be unworkable or productive of more harm than good. Certainly, the building up of such a huge reserve fund as contemplated will involve very grave financial and investment problems, and it remains to be seen what dislocation will result from the heavy taxes which will be imposed. To a great extent, the merits and defects of a plan so far-reaching and necessarily experimental will have to be appraised as the act gradually takes effect, and changes are probably inevitable. Indeed, the necessity for some changes is already so clearly indicated that amendments will probably be enacted before many of the act's provisions become operative.

In considering the act's bearing on an individual financial program, certain reservations must be made at the outset. The constitutionality of the legislation has not been tested, and it appears more than likely that it will be

declared invalid in whole or in part. To be sure, if that happens, efforts will inevitably be made to enact other legislation, with much the same objectives, which can obtain judicial approval; but the essence of a financial program is some reasonable degree of certainty, and no one will be able to place much reliance on the Social Security Act until it or similar legislation has been tested in the courts. Furthermore, as already noted, changes will probably be made as time goes on, and only the contractual parts of the act will offer any real assurance of continuity. Finally, as we shall see, the act is in large part designed to encourage state legislation, and one will only be able to appraise the effect of particular state programs as they are enacted, and tested in the courts and by experience.

Turning to the actual provisions of the Social Security Act, the part which will have the most direct effect on an individual's financial program is that setting up a system of Federal old age annuities. The plan applies to all employees in the United States except those engaged in certain excepted classifications of which agriculture, government service, domestic service in private homes, and casual labor* are the most

* Railroad employees will also be excepted if the separate pension law applying to them is upheld in the courts.

important. Because of these exceptions and because no provisions of the plan take effect until January 1, 1937, it will be convenient in describing the operation of the scheme to use the words "employee," "employer," and "employment" as applying only to the non-excepted occupations, and "wages" as applying only to remuneration received for such employment occurring after January 1, 1937.

Every employee who upon reaching age sixty-five on or after January 1, 1942, has received total wages aggregating $2,000 or more, and who shall have been paid for employment occurring in at least five calendar years, will, if he is not then employed, be entitled to a monthly annuity, based on his total wages, according to the following formula: one-half of one per cent of such wages up to $3,000; plus one-twelfth of one per cent of those from $3,000 to $45,000; plus one-twenty-fourth of one per cent of those over $45,000, except that earnings above $3,000 received from one employer in any calendar year shall be excluded, and that no monthly annuity shall be more than $85. To obtain the maximum monthly annuity of $85, one will have to have received wages of at least $3,000 for forty-three years, and no payment of that amount will therefore be made until 1980. It will be 1950 before pensions run over $50.

The law guarantees a return to each employee of at least 3½ per cent of total wages. If an employee dies before receiving any pension the guaranteed sum will be paid to his estate, as will the unpaid balance if he begins to receive the pension but dies before the guaranteed return has been paid. If at age sixty-five an employee's wages have been less than $2,000, or he has not been paid for employment occurring in each of five calendar years, 3½ per cent of his wages will be paid to him in a lump sum. If one quits employment after passing that age, he will then be eligible for an annuity of the same amount as that to which he would have been entitled had he retired at sixty-five.

This old age annuity part of the Social Security Act provides for definite monthly payments to those who fulfill the requirements and are not in any way conditioned on need. No matter what other resources an eligible employee may have, he will nevertheless be entitled to payment. If the constitutionality of this part of the act is sustained, one may, when formulating a financial program for the future, include in his calculations the annuity to which he will probably be entitled.

A separate part of the act levies income taxes on employees and excise taxes on employers, which, while not specifically allocated to the

fund for the payment of the annuities, are clearly expected to be used primarily for that purpose. Both taxes begin at 1 per cent of wages in 1937, and will be stepped up by one-half per cent every three years, until they reach a maximum of 3 per cent in 1949. Wages above $3,000 paid by one employer to an employee for service in one calendar year will not be taxed, nor will wages paid to employees over sixty-five years of age. Employers will deduct the taxes payable by employees from their wages and will pay both these and their own taxes to the government. An employee's maximum tax will range from $30 in 1937 to $90 in 1949 and thereafter, except that it may be higher in the case of one receiving pay totalling over $3,000 from more than one employer in one year.

Another section of the Social Security Act is simply designed to encourage states to enact old age pension legislation, and provides that the Federal Government will contribute 50 per cent of such pensions, provided certain requirements are met, with its contribution, however, limited to $15 per month per person. This part of the act is of little direct interest to one carrying out an individual plan for security. Such state old age pension laws as are already in effect generally provide for the payment of pensions only to those who actually need them. They really come under

the head of poor relief. It does not seem probable that any state pensions will, for many years to come, be sufficiently certain or adequate to influence individual financial programs to any appreciable extent.

The unemployment insurance part of the act is also designed to encourage states to enact legislation. It sets up no Federal insurance plan, but merely makes use of the taxing power to encourage or force states which have not already done so to enact unemployment insurance laws which will conform to certain standards. A tax of 1 per cent in 1937, 2 per cent in 1938, and 3 per cent thereafter is levied against every employer of eight or more persons not engaged in certain excepted occupations, of which agriculture, domestic service, and government service are the most important.

The Federal Government will not pay any unemployment benefits. The law provides, however, that an employer may deduct from the tax paid to the Federal Government whatever amount he is taxed by a state for unemployment insurance, up to 90 per cent of the Federal tax, provided the state unemployment insurance law meets certain requirements. If a particular employer is relieved from paying the full state tax because he has maintained a good record of continuous employment, he will under certain

conditions be entitled to deduct from the Federal tax the amount which he would normally have had to pay to the state, provided it is not more than 90 per cent of the Federal tax. Few standards are laid down by the Social Security Act, and it is entirely problematical what unemployment insurance programs will be enacted in states which do not now have them. There is nothing in this part of the act which can in any way affect a person's own financial program, except that, if he is located in a state having an unemployment insurance law and expects to remain there, he may, perhaps, take into account the benefits to which he will be entitled. They are not likely to be very great. In most states now having such legislation, the maximum unemployment benefit now payable is not over $15 a week, and the benefits are payable for only limited periods. In addition, the requirements for obtaining the payments may be somewhat arduous and the promptitude of payment uncertain.

There are various other sections of the Social Security Act directed toward the improvement of public health service, child health conservation, nursing service, care of crippled children, provision for the blind, and vocational guidance for disabled persons. Despite the general worthiness and importance of these sections of the act,

they cannot possibly have any effect on an individual financial program.

It is not possible to determine just where the funds will come from to finance the expenditures which will ultimately result from the Social Security Act. Most of the money paid directly to the Federal Government will come from the payroll taxes levied on employers. Very possibly they will be passed in large part to consumers in the form of higher prices. They may possibly, in some cases, be passed on to employees in the shape of wage reductions. They may in part result in lower profits and thus be paid by stockholders. Employees who will benefit will contribute directly to the old age annuity plan, but it may be that to some extent employers will pay these taxes indirectly as wage increases, and pass them on to consumers. Monies paid out by the states will come partly from the Federal treasury and partly either from general state taxes, local taxes, or special taxes levied to meet these particular costs. It appears certain, in any event, that a large part of the money to finance the Social Security Act will come from persons in the lower income brackets. Part of it will come, of course, from those in the higher brackets, who will derive small direct benefit from the act, but it must be remembered that the purpose of the act is partly, at least, to make more definite

provision for those who, in one way or another, now must be taken care of by the government. Those who can afford to do so are now taxed in many ways for the benefit of people unable to support themselves, and they can scarcely hope ever to be relieved of this burden. In any event, if and when the act takes full effect, everyone's pocketbook will be affected directly or indirectly.

In the foregoing discussion, no effort has been made to give the exact language of the act, and many details have been omitted for the sake of brevity. Only those parts of the act bearing on such financial programs as those envisaged in earlier sections of this book have been more than very briefly summarized, it being taken for granted that anyone interested in social security (and who should not be?) will sooner or later study the act itself.

Chapter Sixteen

SOME TYPICAL PROGRAMS

THE details of a suitable financial program depend on so many factors of a purely personal nature that it is quite impossible, with only the bare facts assumed, to say definitely how much life insurance should be taken out, to specify the manner in which the proceeds should be paid, to decide whether annuities or security purchases are most desirable, and to answer the other problems that arise in accumulating an estate. The following examples are not intended to be anything more than suggestive—particularly of the possibility of achieving a comfortable financial position on a moderate income.

Example I

Mr. A. B., married; twenty-five years of age; salary, $3,000; no other resources; continued employment appears assured; group insurance of one year's salary. Took out $5,000 of life insurance when in college, and $5,000 more before marrying, each policy containing a provision

providing for a monthly payment of $50 and waiver of premiums, in the event of the insured's becoming totally and permanently disabled before he reaches age sixty.

A. B.'s present insurance costs him about $165. He wants to arrange an adequate amount of life insurance as quickly as possible. He believes he can manage to pay out about $250 of his annual income for insurance, in addition to saving $200 a year, and plans in general to devote half of any increase in income to building up an estate. He therefore takes out an additional $5,000 of life insurance. The group insurance will suffice for the immediate and first-year requirements, and he believes that his wife will be able to get some sort of a position if he dies at an early age. He therefore stipulates that his $15,000 of insurance is to be payable as a yearly annuity, with payments commencing one year after his death. This will provide his widow with a minimum annual income of $600, which, together with her own earnings, should suffice. If A. B. does not die at an early age, the annuity from the insurance will be much larger, probably sufficiently so to provide her a decent living if she is unable to secure work. From his monthly salary he deposits $15 in a savings account. His will leaves everything to his wife.

When A. B. is thirty years old, his salary has

increased gradually to $4,000, and as he has not forgotten his plan to increase his estate, and as he is still little touched by income taxes, he is devoting $1,000 to security. There are now two children. He has increased his insurance to $20,000, in addition to group insurance, which is now $4,000 in amount. The last policy taken out has been made payable to his wife in fifteen installments, to increase the income payable during the childrens' minority. The children have been made contingent beneficiaries on all the insurance and in his will. His savings now aggregate $1,750. He is currently adding to them about $650 annually and his insurance costs $350. He now feels that some definite provision for old age should be made and takes out an annuity on which he will pay $250 a year until age sixty, when he will begin to receive a life income of about $900, with the return of as much as he pays in guaranteed—the latter provision constituting so much additional insurance payable to his wife.

At thirty-five, A. B.'s salary has reached $5,000, but three growing children have rather interfered with his plan for devoting half of the increase in income to his estate. He has increased his insurance to $25,000, the last policy being payable as an annuity to his wife, with the children as contingent beneficiaries. His insur-

ance costs about $450, and his savings aggregate about $2,500 (some emergencies having caused substanital withdrawals). His business keeps him too much occupied to allow him to give much thought to investments, and he decides to buy another annuity at $250 a year, payable at age sixty. He also buys a government bond for $1,000. His insurance and annuity premiums of $950 leave a little over $4,000, and he is not spending quite all of that.

At forty, with a salary of $7,000, income taxes have begun to be an item, and an increased scale of living has increased living expenses to more than $5,000. About $1,500 is left for estate accumulation. Another government bond has been bought. A. B. has just received a bequest of $10,000. He has long wanted to buy some of the stock of the large corporation with which he is associated. He has confidence in its management and its future and does not believe the price of the stock is out of line with its earnings. He devotes $5,000 to that end and invests the balance in government bonds, as he is still too much occupied with other things to wish to study investments. His wife's health is causing him grave concern, and he decides to trustee both his insurance and his estate under his will. His insurance, together with his securities and cash should aggregate some $40,000, in the event of his

death, after allowance for administration costs and funeral expenses. The trustee is directed to invest the insurance proceeds in bonds and preferred stocks without any restriction, except that one-third must be invested in government bonds. Income is to be paid to the widow, together with such amounts from principal as the trustee believes desirable. After her death, the income is to be divided among the children, with such payments from principal as the trustee judges advisable. When the youngest child is twenty-one, one-half of the principal is to be divided among the children, and the balance when the youngest is twenty-five, the distribution to be accomplished as the trustee sees fit. About the same provisions are incorporated in the will.

The next five years do not go so smoothly. It has been a period of depression. A. B.'s salary has been increased, then reduced. Taxes have gone up and the children have reached the most expensive stage. Medical expense has been heavy, and it has been necessary to use up all of the emergency fund and to sell two government bonds. No other substantial changes affecting the financial program have occurred.

Things change for the better, and at fifty the position is much improved. A. B.'s salary has increased rather rapidly to $10,000. Taxes take some $600, insurance $400 (dividends now being

substantial), annuities $500, living $8,000, and the remaining $500 plus $400 from investments is available for buttressing the security plan. Another guaranteed return annuity costing $500 a year and payable from age sixty is taken out. There is a savings account of about $1,500.

We may leave Mr. A. B. at this point. He will probably add to his government bond holdings, never having acquired a taste for or a knowledge of investments. He may buy more stock in his own company. His position, now comfortable, will improve, even though he spends more for living. He is not wealthy and never will be, but he can look forward to the future with confidence and freedom from worry. Starting with a very moderate salary, which increased at a not very rapid pace, he has lived in reasonable comfort, has always been prepared for almost any contingency, and was well able to go through a period of hard times without great hardship. He has never been a miser and has not even kept his original plan of devoting half of his income addition to his estate. If he wishes to retire at sixty, he will have an assured income of some $2,500 and, because of his adequate insurance, can substantially increase it by selling his securities and buying an annuity, payable during his life and with the return of the principal sum guaranteed, so that if he dies soon after he

retires, his estate will be thereby increased. If he does not retire at sixty, his income will be so much the larger.

Example II

Mr. C. D., age thirty; a salesman on commission; earnings fluctuate from $4,000 to $6,000 a year; no insurance; no resources; recently married; no real assurance of continued employment with present firm.

Mr. C. D. has not had much of an eye to the future, but his marriage has awakened him to the somewhat precarious situation he occupies. While his present employers are not of such financial strength as to justify any great confidence, he has selling ability and believes it will not take long for him to make a new connection, if necessary. He must obviously reduce his scale of living. He determines to take out $15,000 of ordinary life insurance and $5,000 five-year term, convertible into ordinary, at an aggregate premium of about $350, and to keep his living expenses within $3,650, making a total budget of $4,000, as that amount constituted his minimum annual income during the previous three years. If he makes more than that, he will put it in a savings bank. The insurance is payable $2,000 at his death, the balance as an annuity, to his wife. He makes a will, appointing a trust

company as executor, and directs that the proceeds of his estate be used to purchase an annuity for his wife, with return of principal guaranteed, and naming three brothers and sisters as contingent beneficiaries.

At thirty-five, C. D. has saved $7,500, but still has it in the savings bank, partly to his wife's credit, partly to his own, as his situation still makes a rather large emergency fund essential. His earnings since marriage have not been less than $5,000. He converts the $5,000 term insurance into ordinary and takes out an additional $5,000 policy of the same kind, both payable in the same manner as the earlier insurance. Shortly thereafter, his firm fails. He need not hurry to make a connection and waits for a satisfactory opportunity. After six months, he takes a position with a well-established firm, under conditions which he believes assure him of at least $5,000 a year, with a probability of making more. Insurance costs are in the neighborhood of $500, and his plan, as before, contemplates living on the balance of his minimum earnings and devoting anything over that to building his estate. Savings have been reduced to $5,000. That sum appears ample. There are no children nor is there likelihood of any.

At forty, C. D.'s earnings are running at about

$8,000. He is particularly solicitous of his wife, and life insurance has been increased to $40,000, requiring net premiums less dividends of around $750. His living expenses are $6,000, and while preserving savings accounts of $5,000, he has bought three government bonds. His thoughts are turning toward old age and possible retirement. He buys an annuity under the terms of which he will pay $1,000 a year until he is sixty-five, and receive a life income of $3,300, beginning at that age. For some time, he and his wife have rented a home in a suburb, where they have many friends. He can buy the house, which is entirely suitable for his purposes, at $13,000, which he considers a fair price. He takes $4,000 from his savings account, sells his bonds, buys the home, subject to a $7,000 mortgage, and spends $1,000 on alterations.

C. D. is later appointed to a managerial position at $10,000. He lives more expensively but keeps up his insurance and annuities. A large savings account no longer being necessary, he gradually invests whatever is available, putting about half into small government bonds and the rest into small lots of common stock. He has little knowledge of the stock market and contents himself with buying small lots of the more important industrial companies—General Electric, General Motors, Union Carbide, American

Can, and the like. He will probably never have any great grief from these speculations, may make some money, and will have an interest in the financial sections of his newspapers.

Example III

Mr. E. F., age thirty; occupies a government position; salary, $3,000; married, with two children; he has just received a legacy of $25,000.

Government employment is such that he is largely relieved from worry over the usual hazards. At the same time, his salary will not increase very fast, and as his children grow up, expenses will mount. He has been having a pretty hard time carrying $5,000 of insurance, payable to his wife at his death, and making ends meet.

He puts $1,000 in a savings account and buys government bonds to a total of $4,000. He invests $15,000 in well-diversified railroad, utility, and industrial bonds, with an average yield of 4½ per cent, and puts $5,000 into stocks of leading companies. The income from these investments is about $1,000.

His present insurance will be sufficient for administration and other costs at his death, but income from investments will hardly be sufficient for his family if he dies. He takes out $10,000 additional insurance, payable to his

wife as an annuity, with twenty payments certain, the children being named as contingent beneficiaries. Being anxious to assure himself of a more comfortable old age than the government pension will provide, he agrees to pay \$250 annually for an annuity which will pay him a life income of about \$900 after age sixty.

He will thus use some \$450 of his additional income to build up his estate and may increase his living expenses by \$550. As his salary increases, he will be in a position to spend his additional earnings, pretty fair security having already been provided.

His will has become important by reason of the legacy, and after consultation with a lawyer and a trust company officer, he leaves his property in trust for the benefit of his wife. He provides that after his death the proceeds of maturing securities shall be reinvested in securities of the same general type, but authorizes the trustee to sell the common stocks as it may be deemed advisable and to reinvest the proceeds without restrictions, and to sell other securities if it appears wise to do so. Income is to be paid to the widow, and the trustee may pay out additional sums in its discretion, selling securities, if necessary, for that purpose. At the death of the widow, the principal is to be divided between the children, if they are then over

twenty-one; if not, when they both have reached that age.

Example IV

Miss G. H., a school teacher; age thirty; salary, $2,000; sole support of mother; no appreciable resources.

A not uncommon situation. Continued employment at a gradually increasing salary seems assured, and a moderate pension at age sixty, with provision for temporary disability, leave only life insurance and an emergency fund as necessities. Miss G. H.'s income is not large for two people, however, and she is particularly anxious to assure for herself after retirement not merely subsistence, but comfort and means wherewith she can travel. Her mother is old, and, at small annual cost, she purchases a reversionary annuity under which, if she dies before her mother, the latter will receive a monthly annuity of $75. She draws a will appointing her mother as administratrix and sole legatee, the only actual or prospective property consisting of a small savings account and personal effects. Miss G. H. determines to save at least $20 a month and limit living expenses to $1,700 a year.

When Miss G. H. is forty, her mother dies and the annuity contract is automatically canceled. Her salary is $2,500. A new will is drawn,

making a married sister the legatee and administratrix. Savings of about $1,200 have been accumulated. Expenses have been reduced by the mother's death, and Miss G. H. will be able to live comfortably on $2,000. She takes out an annual payment deferred annuity at $500 per year, payable at fifty-five, as she hopes to retire at that age with a reduced pension. As she grows older, she continues to save, and each time the savings account reaches $1,500, a $1,000 single payment deferred annuity commencing at fifty-five is purchased, the sister being named contingent beneficiary under these contracts, which guarantee return of the amounts paid in.

Example V

Dr. I. J. is a physician, with a lucrative practice and considerable resources. At forty, the net income from his profession is about $30,000, and by way of his own savings and bequests, he had at one time accumulated about $60,000. Without giving much thought to the matter, he bought various securities, on advice and tips offered by patients, and now has about half that amount left. He is married and has three children, and his widowed mother is largely dependent on him. Different life insurance salesmen have succeeded in selling

him about $20,000 of insurance, all payable to his wife in a lump sum. $5,000 of this amount is endowment insurance. He has drawn a will, leaving everything to his wife and appointing her administratrix.

The death of a friend whose affairs are in a somewhat similarly disorganized state brings home the necessity of formulating a financial program. The doctor does not want to be bothered by financial affairs and decides to let a trust company take as full charge of them as possible. Conferences with a trust officer, an attorney, and a life insurance agent result in the following disposition of his affairs.

The endowment insurance is not needed and is converted into life insurance with a smaller premium, the excess reserve being refunded. The doctor's life insurance is woefully inadequate for a man of his income and responsibilities, and no definite provision has been made for old age. Additional life insurance of $40,000 is taken out, making a total of $60,000. One policy for $10,000 is made payable to the mother as an annuity, with the wife named as contingent beneficiary in the event of the mother's predeceasing the insured. The remainder is made payable to a trust company as trustee, under a deed providing for payment of income to the wife until her death, and, thereafter, to the

children in equal shares until their majority, when the principal is to be paid to them. The principal is to be invested by the trustee in fixed income securities, no other restrictions being made, and specific authority is given to invest in other securities than "legals." The trustee is authorized to use the life insurance funds to buy securities from the estate in order to insure payment of death duties without the necessity of selling securities at sacrifice prices.

A retirement income policy is also taken out, providing for a monthly life income of $400 a month, beginning at age sixty-five, with payments for ten years guaranteed, if the insured reaches that age, and, if not, for life insurance of $40,000, payable in installments over an eight-year period. This policy will supplement the widow's income, if the doctor dies before the children are entirely self-supporting, and will, together with income from securities and from such other retirement income insurance or annuities as Dr. I. J. may take out from year to year, provide a comfortable income after sixty-five if he survives to that age.

Incidentally, the doctor has been too busy looking after other people's health to pay much attention to his own. He is classed as a substandard risk and has to pay pretty stiff premiums, his only consolation for the heavy

penalty exacted for not taking out adequate insurance earlier consisting in relief at being able to get any insurance at all.

The doctor appoints the trust company as executor and trustee under his will, which is similar to the life insurance trust deed in its terms, and also establishes a living trust. He assigns his securities to the trustee, turns over his insurance policies, and directs that it pay the premiums. He will, of course, have to pay the excess of premiums over income from securities, but plans to pay in at least $5,000 a year from his professional income for that purpose and for the purchase of additional securities.

Dr. I. J. prospers for a period, and his estate grows more rapidly than he had anticipated. He is badly hit by the depression. His office expenses are large; people don't pay their bills; and his fees are smaller. He has to sell bonds to a considerable amount, but his insurance is maintained and it is not necessary to sell stocks. He is, in fact, well prepared.

The foregoing examples have been made as simple as possible. The insurance premiums and annuity returns given are only approximations. No effort has been made to include the details of wills or trust agreements, nor to employ technical or legal language. That is a matter for

attorneys and trust officers to take care of when made cognizant of the testator's or the trustor's wishes.

To be sure, in all of these hypothetical examples, sufficient income has been assumed to make possible, without real hardship, fairly substantial savings in one form or another. They are not intended to be typical or representative of the entire population, but only of that large section of it which is financially able to make provision for the future.

One cannot spend all his income and save money. Carrying out a plan for future security inevitably entails making sacrifices. In the cases given, the sacrifices have been well worth while, but in this respect, at least, the examples are probably not extreme nor out of line with common experience.

There is some temptation to compare the position of our first example, A. B., when we left him at the age of fifty with that of a person whose income and legacy had been precisely equal to A. B.'s, but who had failed to plan carefully for the future. In view of the fact, however, that every reader of this book doubtless has personal knowledge of some case in which unhappiness and distress have resulted from failure to plan and build up an estate, it seems unnecessary to go into harrowing details.

A word may be in order, however, on the subject of the satisfaction which can be obtained from the careful formulation of a financial program and its step by step realization. There is no virtue in money except its purchasing power, and there is something peculiarly repulsive in the miser's enjoyment of the possession of money as an end in itself. Nevertheless, and quite aside from the question of material benefits, in carrying through an intelligently conceived financial plan there is the same sort of thrill as that derived from the solution of any difficult problem. The feelings of one who plans for the future, as the different parts of a security program materialize, are akin to those of an engineer who sees the structure he has designed take form.

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